THE NEW BASEL ACCORD: SOUND REGULATION OR CRUSHING COMPLEXITY?

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THURSDAY, FEBRUARY 27, 2003

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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

THE NEW BASEL ACCORD: SOUND REGULATION OR CRUSHING COMPLEXITY?

Thursday, February 27, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Judy Biggert [chairwoman of the subcommittee] presiding.

Present: Representatives Biggert, Kennedy, Feeney, Oxley, Hensarling, Murphy, Barrett, Harris, Maloney, Lee, Sherman, Frank, Baca, Emanuel, Capuano and Lynch.

Chairwoman BIGGERT. [Presiding.] This hearing of the Subcommittee on Domestic and International Monetary Policy, Trade and Technology will come to order. Without objection, all members' opening statements will be made a part of the record. We would like to welcome everybody here today. I will start with my opening statement.

Good morning. I would like to thank the witnesses for appearing this morning to outline the revisions of Basel Capital Accord, currently under discussion at the Bank of International Settlements. We have two very knowledgeable panels of experts before the subcommittee today, and I look forward to your testimony.

The Basel Accord plays such a critical role in the operations of every bank that any changes to this accord must be closely monitored by the regulators and the Congress. The Federal Reserve and the other regulators have been hard at work seeking improvements in the Basel I structure. I want to thank you for all of your hard work on this complex issue. There is no question that there are flaws in the current system and change is needed. Many of the proposed changes to the Basel Accord are sound and will go a long way to reducing risk in the banking system and ensuring the efficiency of our national banks.

I am, however, very concerned about the complexity of Basel II and the ability to effectively implement it. If we are going to go down the path of changing the primary tool used to protect against excessive risk, then we must make sure that it can be easily implemented and will not result in unforeseen costs. According to the regulators, Basel II will only apply to the largest U.S. financial institutions. However, many of us are concerned that the market could, in effect, force all U.S. institutions to comply with Basel II if they wish to remain competitive. The bottom line is that institu-

tions that do not have the resources to turn the sophisticated models required by Basel II could be forced to consolidate their operations or to severely limit the types of products they offer.

One of my primary concerns is the operational risk capital charge that will come under Pillar I of Basel II. This is a new capital charge which will be included with charges for credit risk and interest rate risk. Operational risk includes in its calculus possible losses from employee misconduct, fraud, system failure and litigation risk. These factors are very difficult to quantify for large banks, and nearly impossible to measure for smaller and medium-sized banks. So I question the logic of imposing a burdensome capital charge on institutions that is based mostly in theory, rather than on hard facts.

Some have asserted that operational risk is simply the catch-all category of Basel II and has been included simply to define risks that are already accounted for in the capital accounts of most institutions. I would like to see if it would make more sense to include these risks under a more flexible Pillar II supervisory structure, instead of lumping them into a mandatory capital charge.

I am also interested in the issue of home host regulators and how Basel II will ensure that foreign regulators will hold their financial institutions to the high standards that U.S. institutions are held. As we saw with the Basel I proposal, too many countries agreed to submit to the capital requirement in theory, but not in practice. I want to be sure that U.S. financial institutions of all sizes are not adversely impacted as a result of Basel II.

There is no argument that Basel I should be updated to better reflect the marketplace in which financial institutions operate today. I want to thank again and applaud the authors of Basel II for their hard work. I am concerned, however, that this process is moving forward at the speed of light and without assurances that there will not be any unintended consequences for U.S. institutions and the U.S. economy as a whole.

I very much look forward to hearing all your testimony, and would again like to thank you for appearing before this subcommittee. I might add that I am Congresswoman Judy Biggert from the state of Illinois and vice chair of this committee, and am sitting in for Peter King, the chairman, who had a conflict today. So in case you have a strange face sitting in this seat, that is why. So I appreciate that.

Now, I turn to the ranking member, Mrs. Maloney of New York, for her opening statement.

Mrs. MALONEY OF NEW YORK. I thank the acting chairwoman, and share many of the sentiments that she expressed in her opening remarks. I am very pleased to welcome Comptroller Hawke back to the committee, as well as Chairman Powell and Vice Chairman Ferguson. It is good to see all of you again, and I look forward to your testimony.

This morning's hearing focuses on a critically important issue for our economy, and the safety and soundness of our financial system-the new Basel Capital Accord, Basel II. The first Basel Capital Accord established the minimum standard for the banks that operate internationally. Basel II is an attempt to build on this progress by allowing financial institutions to hold capital in amounts more re-

flective of risk and changing market conditions. Once implemented, the final Basel II Capital Accord will have profound consequences for the banking industry, our constituents, and the economy as a whole.

Capital standards that are too high cut off credit, especially for borrowers with higher risk profiles. Capital standards that do not adequately protect against loss, risk the safety and soundness of the financial system. At this point in the evolution of Basel II, I believe that there is much to praise in the work of the committee, but serious areas of concern remain.

The effort to align capital more closely with actual risk is a significant improvement over the current one-size-fits-all regime. At the same time, I share the concern expressed by some regulators and banks about the complexity and competitiveness issue raised by placing operational risk under Pillar I of the new Basel Accord. Operational risk is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems, or external events. These are extremely varied scenarios. They include potential natural disasters, terrorist attacks, actions of rogue traders and even litigation risk.

It is my opinion that any final accord not require U.S. institutions to hold a higher amount of capital for operational risk than foreign competitors. Our supervisors are the world's most advanced and our institutions already have a contingency plan and practice risk mitigation for disasters. Even after September 11, when this attack in the heart of the world's financial center, the financial system recovered relatively well, given the scope of the disaster. I do not want to see investments and businesses' continuity planning, backup systems and insurance be reduced because institutions have to devote resources to capital changes and charges for operational risk.

I am also troubled by the potential that U.S. institutions could have to hold additional capital because of litigation risk. In a sense, the U.S. would face the potential competitive disadvantage because our laws protect individuals against loan discrimination and allow them private rights of action.

In addition to operational risk, there are several other issues that I hope will be addressed today. Basel II has yet to decide how host home country application of the accord will be implemented. If this is resolved incorrectly, there is the potential for competitive disadvantage for U.S. institutions if foreign banks are allowed to operate in the U.S. market under capital standards established by their domestic regulators. Additionally, some commentators are concerned that the accord could result in much lower capital requirements for large institutions, adding incentive for more consolidation in the industry. Finally, I look forward to a discussion of whether the final Basel Accord will increase the severity of business cycles by requiring additional capital during economic downturns and thereby contributing to credit crunches.

I thank the regulators for the thousands of hours they and their staffs have contributed to this effort, and I look very much forward to the testimony.

Thank you.

Chairwoman BIGGERT. Thank you.

We are very pleased to have the chairman of the committee here today, Mr. Oxley. Mr. Oxley is recognized for an opening statement.

Mr. OXLEY. Thank you, Chairlady. Let us first of all welcome our distinguished panel. It is good to have all of you back to the committee, Mr. Ferguson from the Fed, Mr. Hawke from the OCC, and of course FDIC Chairman Powell. Welcome back. We look forward to a spirited hearing this morning on the revisions of the Basel Capital Accord currently under discussion at the Bank of International Settlements. We have two very distinguished panels, and I look forward to both the panels' testimony.

I want to first commend the Federal Reserve, the OCC, the FDIC and the New York Fed Chairman McDonough in particular for spearheading the reforms of the Basel Accord. The authors of Basel II have been working diligently for nearly five years to develop a workable regulatory capital regime. The primary goal of Basel II is to provide flexibility and risk sensitivity in the capital adequacy framework. This goal is laudable and will be a vast improvement over the one-size-fits-all approach of the Basel I Accord, and will certainly reduce risk arbitrage under the current system.

This is a topic of critical importance to the banking sector and the economy. If we must sacrifice speed to achieve a workable and appropriate solution the first time, I see no problem in doing so. Basel II will impact not only the largest U.S. financial institutions, but financial institutions of every size and structure. The way banks calculate risk and compete with one another will be dramatically changed under Basel II. Specifically, I am concerned that as it is currently written, Basel II will force a medium-sized institution to either consolidate to compete with the largest banks, or simply cease to offer business lines that the largest banks can offer. According to the Federal Reserve, Basel II will only be mandatory for the 10 largest banks in the U.S., and will be voluntary for the next 10 largest banks. My concern is, what happens to the next 10 institutions and the 10 after those.

I believe that the proposed operational risk charge could also result in unintended consequences, forcing banks to quantify the risk of such intangibles as litigation risk, employee fraud and system failure. Operational risk assessment seems to be much more art than science, and could force institutions to take large capital charges when there is little need for them. Such charges may disadvantage domestic financial institutions by requiring capital charges for factors that are difficult to quantify and are significantly less likely to occur in other countries.

Basel II is extremely sophisticated. The cost and complexity of the proposed Basel II Accord could prove to be overly burdensome for both the institutions and the regulators charged with enforcing the new provisions. This proposal will completely change the way that banks are overseen. As such, the regulators are going to have to retrain and hire new staff and develop new methods for bank supervision. We need to ensure that all parties affected by these changes are prepared to ensure the smooth implementation of Basel II.

In conclusion, I want to reiterate my support for the reform of Basel I. There is no question that change is needed. However, I

strongly urge the Federal Reserve and the other regulators to give serious consideration to all the comments they hear today and the comments that will be made to the third consultative paper before moving forward with any rulemaking. I am troubled that a fast-track timeline for the completion of the Basel II accord has already been established. I understand that the authors of Basel II are seeking final rulemaking to be completed by the end of this calendar year. For a regulatory structure so complex and so far-reaching, we must take a measured approach in order to ensure that all voices have been heard, and that we mitigate or eliminate any unintended consequences of Basel II to the banking sector and the U.S. economy.

I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 54 in the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Chairman.

We are also pleased to have the ranking member of the committee here today. Mr. Frank from Massachusetts is recognized for an opening statement.

Mr. FRANK. Thank you, Madam Chair. I want to express my appreciation to my fellow bookend, the chairman of the committee, for responding as he did when I and others brought this to his attention, and arranging to have this hearing. I think this is very important, and the chairman, I appreciate his responding in this way.

I am going to take the opportunity of having Basel under consideration, particularly with the Fed here, just to say on an unrelated Basel topic, I was pleased to see the recent change with regard to the risk factor and the time of loans. We had a problem because I think there is a pretty good consensus that internationally short-term capital has been a destabilizing effect in some economies. To the extent that capital went in and out in East Asia, for instance, that was problematic.

It was called to my attention that to some extent inadvertently Basel might have been contributing to that because in the risk factor, short-term capital was considered much less risky than long-term capital. That was a clear case of a perverse incentive. I understand that there has now been a modification so that short-term capital is considered, that it is given some kind of benefit from this, that it is only three months or less and that it is focused to a great extent on trade-related. I hope we can sharpen that, because obviously it would not make sense for us to be exaggerating an area of instability. So I appreciate that. This is an example of how we need always to fine-tune these things.

As to this particular subject, I am concerned by several points that were raised to me by some of those who would be the subject of the regulation, and that is obviously often where we get our information. I am particularly concerned about the potential negative competitive effects, both within the United States and internationally. The function that is being regulated here is one that is performed both by banks and by institutions that are not banks. What has been raised to me is the differential impact on the banks, obviously, who would now be subject if it is a Pillar I approach to a capital charge, versus competitors who would not be. That is not just a matter of fairness, because we are not here to help one insti-

tution versus another. It becomes a matter of incentives. It becomes an incentive, to some extent, for institutions interested in this not to be banks, or to be setting up institutions that are not banks, so that we would wind up having set out to increase the regulation, potentially have more of this being done in entirely nonregulated areas. That is troubling.

I am troubled by the potential adverse effect that has been raised by some and will be aired on American versus other institutions, depending on how this carried out internationally. I also am interested, and I particularly appreciate all three of the regulators coming here. I guess we have three out of the four. We do not have the thrift people, but on this one, I suppose they are not involved. I am interested in the legitimate differences of opinion among the regulators. Let me say I hope no one will think that it is somehow improper for various of the regulators to share with the Congress of the United States differences they may have. Once a regulation is promulgated by the appropriate processes, I would expect everybody to be diligent in carrying it out. But trying to paper over what might be legitimate differences in opinion, particularly when we are talking about some fairly technical matters, does not serve anybody well.

So I encourage all to speak out. We know there have been some differences. We would expect that. There are institutional differences. These are not easy questions to answer, and I am appreciative.

I want to join the chairman, too, in cautioning against excessive haste. I must say that when this was first brought to my attention, I spoke to people. I had a very good briefing, and I am very appreciative, that President Monahan of the Boston Federal Reserve arranged for me. One of the first things people told me was that this was nothing to be hasty about. I was told that this was not anything imminent. To some extent, I must say I am a little concerned when I was told that at the beginning, and now I am told, well, you have got to hurry up. I do not see any reason to hurry, and I hope that we will not be told that we are now confronting any fait accompli, that we are in plenty of time to do this.

There does appear to be, let me say in closing, a consensus that we should have some regulation. Whether or not it should be with a formalized capital charge versus increased supervision is very relevant. Certainly while there are always risks in various things, this does seem to me to be qualitatively different from the risks that are involved when you were talking about quantifiable loans. I think the capital charge, a dollar reserve, a money reserve clearly has relevance there. Where we are talking about this area, I must say if I were coming at this myself ab initio would be more inclined to the non-charge regulatory approach, but obviously we will listen.

So I thank the chairman for calling the hearing and I thank the three regulators for coming forward this way. I look forward to what they have to say.

Chairwoman BIGGERT. Thank you.

Members will be recognized for three minutes, if they wish to make an opening statement. Mr. Hensarling of Texas? Mr. Murphy of Pennsylvania? Mr. Barrett of South Carolina? Mr. Kennedy of Minnesota?

Mr. KENNEDY. Thank you.

I would just echo the concerns that this does not create the international competitiveness that puts American financial institutions at a disadvantage. I am very interested in hearing your testimony. Thank you for coming.

Chairwoman BIGGERT. Thank you.

Mr. Emanuel of Illinois?

Mr. EMANUEL. Thank you. I obviously look forward to their testimony and obviously the Q&A afterwards. Thank you.

[The prepared statement of Hon. Rahm Emanuel can be found on page 56 in the appendix.]

Chairwoman BIGGERT. Okay. Ms. Lee of California?

Ms. LEE. Thank you, Madam Chair.

I just thank you for the hearing and look forward to the testimony. Specifically, I would like to listen closely to how Basel II really will affect smaller banks, as it relates to the new capital requirement systems. I look forward to also returning to my district to talk to our banks and representatives in the Bay Area about it. Thank you.

Chairwoman BIGGERT. Thank you. Mr. Baca of California?

To our other members that are here, Mr. Lynch, do you have an opening statement? Do you have a motion for unanimous consent to make an opening statement?

Mr. LYNCH. I do. I would ask unanimous consent that I be allowed to make a statement, Madam Chair.

Chairwoman BIGGERT. Without objection.

Mr. LYNCH. Thank you very much.

I do want to thank all of the witnesses here this morning who have come forward to help the committee with their work. I in particular want to thank David Spina and Maureen Bateman from State Street Corporation for coming here today. I am interested in hearing all of the testimony, but especially the testimony of those institutions that will have to eventually live under anything that is eventually adopted. I think that Mr. Spina will be uniquely situated to address that perspective.

I expect that at some point, Madam Chair, we are going to be pulled out. There is a members only briefing with Tom Ridge on homeland security at 11 o'clock. I hope that at some point during the testimony here this morning and this afternoon, that we will hear from all of those, and especially Mr. Spina, on the specific issue of how will this regulation, especially Pillar I of Basel II, how will that affect institutions that have to work under that regulation going forward; how will that affect, as others have mentioned, the competitiveness of some of our institutions in this country. I want to echo the remarks and the concerns, or amplify the concerns of Mr. Frank about what this really would do in an international competitive situation with some of the banks from the European Union.

I think there is much to be worked through in this. I hope, again, as Mr. Frank said, that this is not a fait accompli and that we really have an opportunity to look very hard at what we are about to do here, and that we protect the institutions that have protected our investors and our citizens so well in the past.

Thank you, Madam Chair. I yield back my time.

Chairwoman BIGGERT. Thank you.

Mr. Capuano, would you have an opening statement?

Mr. CAPUANO. Yes, Madam Chairman. Again, I would ask unanimous consent that I be able to make a statement.

Chairwoman BIGGERT. Without objection.

Mr. CAPUANO. Thank you, Madam Chair.

Again, I will be very brief. First of all, I thank you all for coming here. I actually thank you very much for a lot of the information we have gotten. This is a relatively complicated area. Actually, it is a very complicated area, and we need all the information we can get. I thank you all for providing that.

For me, when I see these types of things, I see new regulation. I have never been terribly opposed to regulation per se. It is not a swear-word for me, but the question is obviously reasonable, amounts of regulation is one thing. But more important than anything else, which is my big concern with the drafts that are here, is the concept of a level playing field. I know it is nobody's intention to not create a level playing field, but particularly with the new world that we have in financial services, level playing fields are not necessarily always made based upon the organizational structure of a particular entity engaged in a business line.

Right now, I do not know what a bank is anymore. I know people have charters, but who is a bank? Realtors are banks sometimes. banks are sometimes realtors. Who is an insurance company? Who is not? No one knows anymore. So for me, I would simply encourage, and again, I am sure you have already considered it, but as you continue, to strongly encourage that you take the old concepts of organizational structure, knowing that they are in flux, knowing that they are changing daily, and to try to create that level playing field based on a business line, as opposed to an organizational structure both domestically and internationally. I know you are trying to do that, but to me that is the most important aspect here, and I look forward to helping you; or actually hopefully not having to help you to create that level playing field.

Thank you.

Chairwoman BIGGERT. Thank you.

Let me just say before introduction of the witnesses that there is a briefing at 11 a.m., but I intend to continue on with the hearing. So I know that some of our members will be leaving, but hopefully they will return following that briefing, but we will continue with the hearing.

Let me now introduce the members of the first panel. Dr. Roger W. Ferguson, Jr., was appointed to the Federal Reserve Board in 1997 and has been vice chairman of the Board of Governors since 1999. Dr. Ferguson was recently appointed chairman of the Committee on Global Financial Systems at the Bank of International Settlements in Basel, Switzerland. Before becoming a member of the board, Dr. Ferguson was a partner at McKinsey and Company, an international consulting firm. He received a B.A. in economics, a J.D. in law, and a Ph.D. in economics, all from Harvard University.

Next on our panel is John D. Hawke, Jr., who has served as Comptroller of the Currency since 1998. Prior to his appointment as Comptroller, Mr. Hawke served for three and a half years as

Undersecretary of Treasury for Domestic Finance, where he oversaw the development of policy and legislation in areas of financial institutions, debt management in capital markets, and served as chairman of the advance counterfeit deterrence steering committee and is a member of the Securities Investor Protection Corporation. Mr. Hawke has a B.A. in English from Yale University and a law degree from Columbia University.

Donald E. Powell is the 18th chairman of the Federal Deposit Insurance Corporation. Prior to being named Cairman of the FDIC, Mr. Powell was president and CEO of the First National Bank of Amarillo. He received his bachelor of science degree in economics from West Texas State University, and is a graduate of the Southwestern Graduate School of Banking at Southern Methodist University.

Thank you all, gentlemen. Without objection, your written statements will be made a part of the record. You will each be recognized for a five-minute summary of your testimony. After all of you have testified, then we will recognize members for five minutes each to ask questions of you. If that is agreeable with you, we will begin with Dr. Ferguson for your testimony.

STATEMENT OF ROGER W. FERGUSON, JR., VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. FERGUSON. Thank you very much, Acting Chairwoman Biggert. Representative Maloney, members of the subcommittee, and also Representative Oxley and Representative Frank.

It is a pleasure to appear before you on behalf of the Board of Governors of the Federal Reserve System to discuss the evolving new capital accord, Basel II. I would also at this point like to thank my colleagues here at the table for their active participation over the last four or five years in developing Basel II, and to recognize the great work not only of the Federal Reserve Staff, but also the staffs of the FDIC and the OCC who have been active participants as well.

Basel II is a complex proposal with many associated issues, but the format this morning requires that I be brief. As you have already indicated, the board has prepared a longer statement. I am pleased that this will be part of the record. This morning, I will limit myself to only a few highlights from that statement.

There are several points that I believe should be emphasized at the outset before I address some of the questions you have raised. First, in the United States, as Representative Oxley has pointed out, Basel II will only be mandatory for a small number of large, complex banking organizations; about ten. Other entities may adopt it if they wish, although we do not think it will be cost effective for any but the larger organizations. All adopters, both mandatory and voluntary, will be required to construct the necessary infrastructure to produce and validate the key risk measurement inputs to the Basel II framework.

Secondly, only those U.S. banks that adopt Basel II will be required to hold capital for operational risk. Third, beyond the required core group of ten or so, and what we expect at least initially may be another ten or so adopters by choice, all the other thou-

sands of banks in this country will remain under the current capital structure known as Basel I.

Finally, the process of developing the Basel II proposal has not been hasty. It has involved a truly unprecedented dialogue with banks on a wide range of risk management and capital issues. That dialogue continues, and in fact will never be over. The Basel Committee will soon be issuing a revised set of proposals that we intend to use as the basis for a U.S. domestic comment process during the spring and the summer. The Basel Committee intends to approve a revised proposal late this year, while we believe that the associated U.S. rulemaking procedures, which will be the usual ANPR and NPR procedures, will be completed some time next year. Again, I do not necessarily believe that to be a hasty timetable.

Implementation could start as early as late 2006, but no U.S. bank will be permitted to adopt Basel II until its infrastructure for estimating the required inputs has been approved by its supervisor. It is important to emphasize that modifications to the Basel II proposals will be possible both before and after these critical milestone dates. As supervisors, we will be seeking continually to improve our understanding of the impact of the new rules and will be prepared to make necessary changes as appropriate.

With these preliminary observations, let me quickly sketch out why we believe Basel II is necessary for the large, complex, internationally active U.S. banks. First, while Basel I is still quite effective for most banks, it is too simplistic effectively to capture the increasingly varied and complex operations of our largest banking organizations. Indeed, the Basel I capital ratios are too often misleading. Congress, you will recall, has required that these ratios be used as a mechanism for filtering the activities of banking organizations and guiding supervisory assessments of financial condition, including the need for supervisory intervention. Unfortunately, current trends will continue to erode the usefulness of the existing capital ratios for the largest banks unless significant steps are taken to address this concern.

Second, risk measurement and risk management practices have improved dramatically since Basel I was created. Basel II is designed to capture those changes and to induce banks to carry them forward in their own internal risk management. Third, the necessity to induce banks to apply stronger and more comprehensive risk management techniques has been highlighted and heightened by the increased banking concentration both here and abroad. In this country, we now have a small number of very large banks and bank holding companies whose operations are tremendously complex and sophisticated. Weakness, let alone failure, at any one of them has the potential for severe adverse macroeconomic consequences. The regulatory entity for these entities must therefore encourage them to adopt the best possible risk measurement and risk management techniques.

If we do not move in this direction, the risk of a problem at one or more of these entities will rise, providing us with only two unattractive options; on the one hand, increased risk of financial instability, or the adoption of much more intrusive supervision and regulation.

Time does not permit me to describe the mechanics of the Basel II proposal, its risk inputs, regulatory formulas, use of internal estimates, et cetera. These are all in my longer statement, which again I urge you to read for your background. I would like instead to spend my remaining time addressing a small number of issues that some banks have raised with you and with us.

A key feature of the Basel II framework is an explicit capital requirement for operational risk; the risk that losses can incur not from extending credit, but rather because processes, systems or people fail, or some events occur. This aspect of Basel II has generated aggressive criticism from those who feel that it would affect them adversely. But clearly, operational risk is real, and indeed often produces noteworthy losses; rogue traders, fraud and forgery, settlement failures, inappropriate sales practices, poor accounting and lapses of control, slippages in custodian and asset management, and large legal settlements for alleged losses caused by bank action or inaction.

Indeed, I think my fellow supervisors would agree that our staffs have spent no little time dealing with operational risk issues in the last several years. Basel I bundled op risk with credit risk, which is to say it effectively ignored it. An early decision was made in the development of Basel II to unbundle other risks from credit risk, and to treat each explicitly. Most of the other risks are sufficiently modest so that they can be addressed by supervisory oversight, but the Basel Committee decided that operational risk is so important that it should be treated similarly to credit risk, with an explicit capital charge.

The current Basel II proposals reflect this treatment, and thus the large U.S. banks required or opting to use the internal ratings-based Basel II capital requirement will also be required to hold capital.

Chairwoman BIGGERT. Dr. Ferguson, if you could sum up. I think we will get to a lot of this in the questions also.

Mr. FERGUSON. Okay. I have a number of other points to make, but I am looking forward to responding to your questions in that regard.

Let me also, if I could, speak to one other issue, and then conclude by saying that there is clearly strong agreement among the regulators that it is important to move past Basel I. I was pleased to hear the subcommittee in the opening comments address that. There are a number of technical issues which I am eager to address today, but at this stage I will sum up and allow others to speak.

Thank you.

[The prepared statement of Roger W. Ferguson, Jr. can be found on page 74 in the appendix.]

Chairwoman BIGGERT. Thank you very much, Dr. Ferguson.

Mr. Hawke?

STATEMENT OF HONORABLE JOHN D. HAWKE, JR., COMPTROLLER, OFFICE OF THE COMPTROLLER OF CURRENCY

Mr. HAWKE. Thank you, Madam Chairwoman, Congresswoman Maloney, Chairman Oxley, Ranking Member Frank, and members of the Subcommittee. I am pleased to have this opportunity to present the views of the OCC on the Basel Committee's proposed

revisions to the 1988 Capital Accord. I think it is essential that Congress have the opportunity to express its views on any regulatory changes that could affect the operations and competitiveness of our banking system, and the Subcommittee is to be commended for its initiative in this regard.

For the past few years, the Basel Committee, of which the OCC is a permanent member, has been working to develop a more risk-sensitive capital adequacy framework. The Committee has established a target date of December 2003 for the adoption of a revised Accord Basel II. Accordingly, the OCC and the other U.S. banking agencies have already begun the process of considering revisions to the current U.S. capital regulations through our domestic rulemaking process. This means publishing proposed revisions for public comment and carefully considering the comments that we receive.

I want to assure the Subcommittee that the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not sign off on a final Basel II framework until we determine through this notice and comment process that any changes to our domestic capital regulations are reasonable, practical and effective.

Despite the enormous effort and great progress made by the Basel Committee, serious questions remain about some aspects of the Basel II framework. The first issue is complexity. One of the goals of Basel II is to encourage financial institutions to improve their own ability to assess and manage risk, and for supervisors to make use of bank self-assessments in setting regulatory capital. But before we can do that, banks have to demonstrate that their systems, and the capital determinations that flow from them, are reliable.

Thus, Basel II sets detailed and exacting standards for rating systems, control mechanisms, audit processes, data systems and other internal bank procedures. This has led to a proposal of immense complexity—greater complexity, in my view, than is reasonably needed to implement sensible capital regulation. I believe we have to avoid the tendency to develop encyclopedic standards for banks, which minimize the role of judgment or discretion by banks applying the new rules or supervisors overseeing them.

Moreover, Basel II has to be written in a manner that is understandable to the institutions that are expected to implement it, as well as to third parties. We have already seen problems in understanding the instructions for the qualitative impact study that has just been finished. It is imperative that the industry and other interested parties understand the proposed regulatory requirements.

The second issue is competitive equality. We need to think carefully about the effects of Basel II on the competitive balance between domestic banks and foreign banks, between banks and nonbanks, and between large internationally active banks in the United States and the thousands of other smaller domestic banks.

In the United States, we have a sophisticated, hands-on system of bank supervision. The OCC has full-time teams of resident examiners on-site at our largest banks—as many as 30 or 40 examiners at the very largest. In other countries, by contrast, supervisors may rely less on bank examiners and more on outside audi-

tors to perform certain oversight functions. Given such disparities in the methods of supervision, it seems to us inevitable that an enormously complex set of rules will be applied much more robustly under our system than in many others. Thus, the complexity of the rules alone will tend to work toward competitive inequality.

There is also a concern about the potential effect of Basel II on the competitive balance between large banks and small banks. As it is likely to be implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with the largest banks subject to Basel II-based requirements and all others subject to the current capital regime.

We expect that banks subject to Basel II will experience lower capital requirements in some lines of business than banks that remain under the 1988 Accord. That may put smaller "non-Basel" banks at a competitive disadvantage when competing against the large banks in these same product lines. We should avoid adoption of a capital regime that might have the unintended consequence of disrupting our current banking structure of small, regional and large banks, and take steps to mitigate the adverse effects on the competitive balance between our largest and other banks.

Finally, for many banks, the principal source of competition is not other insured depositories, but non-banks. This situation is especially common in businesses such as asset management and payments processing. While differences in regulatory requirements for banks and non-banks exist today, many institutions have voiced concern that implementation of Basel II may exacerbate those differences to the disadvantage of depository institutions.

The third issue is operational risk, perhaps the most contentious aspect of the proposed revisions to the Basel Accord. The OCC supports the view that there should be an appropriate charge for operational risk. But I have also consistently argued before the Basel Committee that the determination of an appropriate charge for operational risk should be the responsibility of bank supervisors under Pillar II, rather than be calculated using a formulaic approach under Pillar I. I regret to say that I have not been able to persuade the Committee to adopt this approach.

Basel's operational risk proposal has changed considerably since it was first introduced. The current proposal, especially the option of the Advanced Measurement Approach (AMA), which the OCC helped develop, is a significant improvement over earlier proposals. The AMA is a flexible approach that allows an individual institution to develop a risk management process best suited for its business, control environment and risk culture. Nevertheless, the OCC believes that more work needs to be done to develop guidelines for the appropriate treatment of operational risk.

Finally, calibration. It has been a specific goal of the Basel Committee that the revised Accord be capital neutral. In other words, the aim is to maintain the overall capital of the banking industry at levels approximately equivalent to those that exist under the Basel Accord today. To ensure that overall capital in the banking system does not fall, the Committee has proposed the use of a minimum overall capital floor for the first two years following implementation of the new Accord.

While the OCC supports a temporary capital floor, it does not believe that a reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an undesirable outcome. A drop in required capital is acceptable if the reduction is based on a regulatory capital regime that reflects the degree of risk in that bank's positions and activities. But, we are not yet at the point where we can really make a confident judgment about the impact of Basel II on capital levels. QIS-3, the latest qualitative impact study, was based on an incomplete proposal and was applied by the banks without any of the validation or control that would be present when the new regime is in full force. Thus, an effort to calibrate new capital requirements based on QIS-3 must confront great uncertainty. This uncertainty further illustrates the importance of moving cautiously before we incorporate Basel II into our domestic capital rules.

In conclusion, as I indicated earlier, the OCC strongly supports the objectives of Basel II. This summer, the OCC and the other banking agencies expect to seek notice and comment from all interested parties on an advanced notice of proposed rulemaking that translates the current version of Basel II into a regulatory proposal. If we determine through our rulemaking process that changes to the Basel proposal are necessary, we will press the Basel Committee to make changes. We further reserve our right to assure that any final U.S. regulation applicable to national banks reflects any necessary modifications. Given the importance of this proposal, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee, both in theory as well as in practice.

Thank you very much.

[The prepared statement of Hon. John D. Hawke, Jr., can be found on page 94 in the appendix.]

Chairwoman BIGGERT. Thank you.

Mr. Powell, you may proceed.

STATEMENT OF HONORABLE DONALD POWELL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. POWELL. Thank you, Madam Chair and members of the Subcommittee.

Since 1999, the Basel Committee has worked hard to develop a new international capital framework referred to as "Basel II." I entered this effort late in the game, having joined the FDIC eighteen months ago, and I am grateful to my fellow supervisors and their staff for the efforts to get us where we are today.

Bank capital is critical to the health and well-being of the U.S. financial system. An adequate capital cushion enhances the banks' financial flexibility and their ability to weather periods of adversity. The conceptual changes being considered in Basel II are far-reaching. For the first time, we would create one set of capital rules for the largest banks and another set of rules for everyone else. Under the proposed new Accord, large banks will feed their internal risk estimates into regulator defined formulas to set minimum capital requirements. Under the new formulas, minimum capital requirements for credit risk would tend to be reduced, with

additional capital being held under a flexible operational risk charge.

Admittedly, the existing capital rules for the largest banking organizations have not kept pace with these institutions' complexity and ability to innovate. Basel II intends to align capital with the economic substance of the risks large banks take. That is a worthy goal. Nevertheless, before regulators and policymakers embrace Basel II, the FDIC has concluded that three critical issues need to be addressed.

First, minimum capital requirements must not be unduly diminished. Lower capital requirements for credit risk, together with a set of more flexible capital charges imposed by supervisors, may work well in theory. Experience demonstrates, however, that it is difficult for supervisors to impose substantial capital buffers in the face of stiff bank resistance, especially during good economic times. Substantial reductions in minimum capital requirements for the largest U.S. banks would be of grave concern to the FDIC.

Second, we must be satisfied that the regulators can validate the internal risk ratings. By allowing the use of banks' internal risk estimates, Basel II represents a significant shift in supervisory philosophy. This new philosophy demands that we have in place uniform and consistent interagency processes that are effective in assessing whether the banks' internal estimates are reasonable and conservative. These processes are being developed by the agencies, but the work here is not final.

Third, we must understand and assess the competitive impact of Basel II. Basel II will most likely be mandatory only for a group of large, complex and internationally active U.S. banking organizations. This mandatory group of institutions does not include numerous large regional banking institutions, as well as thousands of smaller community-based banks and thrifts. If Basel II provides the largest U.S. institutions some material economic advantage as a result of lower capital requirements, the "non-Basel" institutions may find themselves at a competitive disadvantage in certain markets. This "bifurcated" system raises the concerns of competitive inequity between these groups of banks.

banks themselves are best equipped to evaluate these issues. We regulators, in turn, must provide them with straightforward dollars and cents information about the Accord and the capital they or their competitors may be required to hold.

The FDIC will work with our fellow regulators to address these issues in the months ahead. Presuming these threshold issues are satisfactorily resolved, numerous Accord implementation issues still need to be decided. I will touch on two of them in my remaining time. To fully adopt the internal ratings-based approach proposal in Basel II, banks must make significant investments in staff expertise, internal controls, and make the necessary structural and culture changes. Qualifying for and living with Basel II will bring complexity and burden. Of course, a degree of regulatory complexity is unavoidable as banks seek to have capital tailored to their individual risk profiles. But these burden considerations, and the desirability of testing the waters with the new Accord, suggest that the universe of "Basel II banks" initially will, and should be, relatively small.

The proposed capital charge for operational risk has attracted much discussion. Bank failures related to operational risk can be traced overwhelmingly to one common theme-fraud. This is certainly part of the reason banks hold capital. Whether the operational risk charge is called Pillar I or Pillar II is not of critical significance to the FDIC, provided the regulators implement this approach in a commonsense, flexible manner.

Finally, in implementing the Accord, let us not overlook the importance of credit culture and the virtues of conservative banking. The Basel II internal risk estimates are likely to be only as robust as the credit culture in which they are produced. Rigorous corporate governance structures, effective internal controls and a culture of transparency and disclosure, all play an important role in ensuring the integrity of the banks' internal risk estimates. It will be important for supervisors not to place excessive reliance on quantitative methods and models. Models can be wrong and losses can depart from historical norms. That is why we need a margin for error. To repeat an earlier point, that is why we need capital.

Thank you.

[The prepared statement of Hon. Donald Powell can be found on page 145 in the appendix.]

Chairwoman BIGGERT. Thank you very much. We will now have questions. I will yield five minutes to the chairman of the Financial Services Committee, Mr. Oxley.

Mr. OXLEY. Thank you, Madam Chairwoman. I appreciate that.

Gentlemen, Mr. D. Wilson Ervin, representing Credit Suisse First Boston, will be testifying on the second panel. Always a problem with the second panel is that members are distracted and so forth, so I was looking over his testimony and he had some very pointed criticisms of Basel II and I thought maybe I would bring them up with you, and see how you respond. While giving some very good support and praise for the work of this project, he cites four macro issues that arise out of the proposed accord that he has some problem with. I would just like to ask each one of you to respond to those specific macro concerns.

The first one is, as Mr. Ervin says, the current Basel proposal is too complex, too costly, and too inflexible to provide a robust, durable framework for bank supervision going forward. Implementing the proposed accord may have the effect of freezing the development of good risk management and locking it into an ″early 2000″ mindset. I am not quite sure what that means, but that is a good place to start.

Dr. Ferguson?

Mr. FERGUSON. Certainly. I appreciate your giving me a chance to respond to this. First, on the question of complexity, the answer is Basel II is more complex than Basel I. There is no doubt about it. The question of why it is complex is the key issue here. It is complex because Basel I was a one-size-fits-all, very simplistic approach that did not reflect or does not currently reflect the way the largest banks manage their capital and manage their operations. As we went forward with Basel II, in consultation with the industry, as we came out with a variety of proposals, many in the industry asked for a slightly different approach, more flexibility, different options. What one ended up with was indeed a system that

moved from one-size-fits-all to a system that is appropriately much more risk-sensitive, that reflects the range of activities that banks undertake, the range of risks that they take, and consequently is more complex.

So the question is not that it is too complex, but I think it is complex because it reflects the complexity of the banking industry.

Mr. OXLEY. What about too costly?

Mr. FERGUSON. Second question, costly. I think of cost in terms of the cost-benefit analysis. There are two ways that I have thought about this cost problem over the last year or so when I have been actively involved in this hands-on way.

First, many of the largest institutions are already going down this path. As I have gotten involved with this, as I have worked with the staff, I have discovered a large number of our large and complex institutions already approach risk management in a way that is quite similar to what Basel II is doing. They need some incentive. They need some encouragement. Some are laggard, which is one of the reasons why going in this direction is appropriate, but they have found it in their own business interest to start to manage in a way that is quite consistent with what Basel II has asked for.

The second question with respect to cost is what is the benefit that one gets out of it, because it is more costly than simplistic approaches, but on the other hand there are clear business benefits, and I think national benefits to having banks that are managed in a way that focuses much more on the variety of risks that they face and the various portfolios, and recognize that there is more than a one-size-fits-all approach. So I look at this in terms of cost-benefit, not just being too costly.

Mr. OXLEY. Too inflexible?

Mr. FERGUSON. I think that is also a misunderstanding. As I tried to indicate in my opening remarks, one, I think Basel II and the interaction and development of Basel will allow for an ongoing improvement with respect to Basel. As my colleague Mr. Hawke indicated, the expectation would be that this would be implemented originally in the very first part of 2007, but there would be ongoing review through 2008 and 2009. So there is a chance to continue improvements. Obviously, through both Pillar I, Pillar II, and Pillar 2I, as new risk management techniques take hold, and there are new ways of estimating some of the important parameters, that the business community developed, the banking community develops, or that we develop, those can and will be reflected in the capital requirements. All we are asking banks to do is estimate some parameters, but the process by which they estimate them, as long as we as regulators can validate them, can and should evolve over time with the best risk-management technology and techniques that emerge as we go into the 21st century.

Mr. OXLEY. Thank you, Dr. Ferguson.

Let me just go to Mr. Hawke. Complex, costly, inflexible?

Mr. HAWKE. Mr. Chairman, here on the table is the current version of Basel II. It is infinitely more complex than it needs to be. It is not complex simply because we are dealing with a complex subject. It is not only complex, it is virtually impenetrable. I defy

ordinary people to get past page three or four of most of the parts of this document.

Mr. OXLEY. Ordinary people do not read that stuff.

[Laughter]

Mr. HAWKE. Ordinary people called bank examiners have to apply it.

Mr. OXLEY. You are calling bank examiners ordinary people?

[Laughter]

Mr. HAWKE. That is not a slur.

[Laughter]

It is complex because it reflects a mindset on the part of a controlling view in the Basel Committee that this needs to be a highly prescriptive document that addresses every nicety and every aspect of capital regulation. Every loophole is plugged. Every nuance is addressed. It reflects a pathological aversion to the exercise of supervisory discretion. That is why it is as complex as it is. It does not need to be this complex, and I have argued this point in the Committee for the past four years.

Second, as to whether it is too costly or not, I think that depends on what the final impact is. If the capital of banks is really reduced to a point where it is better reflective of risk and that reflects a capital saving, then the cost may be entirely justified.

And, quickly, as to the final point, whether it locks us into a year 2000 approach to risk measurement, I have thought for a long time that that was a danger. We have in a sense here a governmentally dictated approach to capital measurement. It is an approach that has an awful lot to say for it. But it is our approach, and banks are going to have to make an investment in implementing the approach that we put out there in final form. That does run the risk of inhibiting the development of new and better risk measurement systems, because banks will already have made the investment in the system that we have told them that they are going to have to follow. So I think that is a danger.

Mr. OXLEY. Thank you.

Chairman Powell, could you give us a succinct Texas response to those three issues?

Mr. POWELL. First of all, I have never met a normal examiner.

[Laughter]

I am just kidding. Again, being a former banker, I have never seen a regulation that was not complex. They tend to be all complex. I think there is a need for a certain complexity in the regulations. Having said that, I think as it evolves over time, the complexity is diluted to some extent in real practice. I think regulators have a history of working with institutions to resolve complexities. So I am not as concerned as much about the complexity as some, and perhaps it should be complex. I am more concerned about making sure that Basel II maintains adequate capital ratios. I think it is necessary. I think it is important when we are addressing deficiencies within the system. We must and should have better risk models. Whether those models are more complex, again, depends upon the view. But my overriding concern is that those models do not produce watered-down capital requirements of these that are in existence today.

Mr. OXLEY. Thank you.

Thank you, Madam Chairwoman.

Chairwoman BIGGERT. Thank you.

Mrs. Maloney, the ranking member, is recognized for five minutes.

Mrs. MALONEY OF NEW YORK. I defer to the ranking member, Mr. Frank.

Mr. FRANK. I thank the gentlewoman. I want to say, as I read this, part of what I get is that when people have said this should have been Pillar II instead of Pillar I, the defense in part is yes, but it is a Pillar I that looks like Pillar II. Well, if it looks like Pillar II, why don't we make it Pillar II. Mr. Ferguson?

Mr. FERGUSON. Again, a good question. Let me explain what it does do and how it is different from Pillar II. The importance of Pillar I falls into three categories, Congressman Frank. One is transparency. Under Pillar I, you disclose the capital that you are holding for a particular purpose.

Mr. FRANK. Let's do these one at a time. Is there anything that would stop you from saying it is Pillar II, and as a transparency requirement, that as part of your administering it as a Pillar II, you would require that that amount of capital that you can show be made public?

Mr. FERGUSON. There is nothing that stops us from going that route.

Mr. FRANK. I just like to do things one at a time. It seems to me on transparency we have got a tie.

Mr. FERGUSON. Absolutely right. Let me go to Pillar II, the other elements of why Pillar I is important. Pillar I allows for more rigor in this process, and I frankly have to disagree with some of the tone I have heard from the subcommittee that this is very hard to quantify. There are a number of banks that already are doing risk management and risk measurement in the area of operational risk. Though not as quantifiable as credit risk, I would admit, it is more than just sort of a vague gut instinctive feel. Through the use of databases and a variety of statistical techniques, which I would admit are complex, it is possible to do a better job of quantification than perhaps some might think, and there are banks that are doing that.

Now, the difference between Pillar I and Pillar II in that regard is that the enforcement of a rigorous, more easily quantifiable, more verifiable approach works much better under the authority of Pillar I than the give and take, back door, quiet negotiation that exists under Pillar II.

Mr. FRANK. I appreciate that. Let me ask you, then, about this one. The banks that have quantified this, do you think they have on the whole come up with adequate capital set asides to meet those risks under the current situation?

Mr. FERGUSON. The answer is I believe that is probably true. Let me elaborate. It is not just the banks that have quantified it in the way that we are thinking about.

Mr. FRANK. I understand. I appreciate it. You know, this is not the easiest stuff in the world, so you have got to be a little bit compassionate towards some of us who are learning this because this is our job. To be honest, I do not expect this to be coming up at a town meeting, even if I had one, and I do not have one. I need

to go one at a time here. I am just talking now; you said that some people have said that it cannot be quantified, and you have said it can be with a reasonable approximation. We know you do not get precision.

My question, then, is very specific. To the extent that you are familiar with those that have quantified, have they tended then; have they put up enough money? The second part of that question would be this, under the Pillar I approach, would the amount of capital a bank would be required to put up approximate what they are now doing—those that have quantified?

Mr. FERGUSON. You have led me to the point that I wanted to get to anyway, thank you very much.

Mr. FRANK. If I got to where you wanted to go, maybe it was not such a good way.

[Laughter.]

Mr. FERGUSON. Two responses to your two questions. First, the answer, as I quickly check with staff here, yes, we would say that those that have been on the cutting edge in terms of using a more quantified approach to operational risk have ended up with a result that seems to us to be within the ballpark of reasonableness; point one.

Point two, one of the major issues that one must understand in this discussion is that many of the banks that are most vociferous in opposition, and in fact the vast majority of U.S. banks, hold excess regulatory capital. The total amount of capital that we think would be required by quantifying op list would not go up. The difference would be in transparency and disclosure, because it would become clearer that they are holding some of that capital that they now describe as excess specifically for operational risk.

Mr. FRANK. But we have agreed that you could under a Pillar II approach deal with that by requiring that.

Mr. FERGUSON. Right, but I am responding to your question about whether the total amount of capital would have to go up, and the answer is no, the total amount would not.

Mr. FRANK. Let me ask you one last question, and then I want to turn to the others briefly. The people who make the decision to avail themselves of this capacity, the storage. We are talking here about people who decide they are going to have one of these banks be the place where they store stuff. My impression is we are not talking here about individual consumers, but entities that are themselves sophisticated institutions. Is that generally correct?

Mr. FERGUSON. Yes, generally speaking.

Mr. FRANK. Okay. Then here is my question, because I raised the question in some informal conversations, why we could not just do it with publicity, et cetera, and people said, well, why doesn't that work for deposit insurance, and does that mean you have to have deposit insurance. It was a reasonable question. I thought about it, and of course part of the problem is that many of the people who make a decision to put their accounts in a bank are unsophisticated consumers or they may be people who are sophisticated about some things, but the transactions costs of trying to figure out what was a safe bank and what was not would be impossible. I put myself in that category. I want to put my money in a bank. I do not want to have to check all these other things.

But with regard to the people who avail themselves of this particular service, it would seem to me that if you went ahead and used the transparency authority you had and published how much capital they had, et cetera, made them publish it, and if in fact you thought it was inadequate and said so, that given the sophisticated nature of the consumer in this case, that that would be a pretty good protection. What is the matter with that?

Mr. FERGUSON. I think that it does not reflect two major points here. One is, as I have said, the negotiation and the discussion between the regulators and the institutions is one in which having the Pillar I capability allows us to get to reasonable answers.

Mr. FRANK. One point at a time. Wouldn't the fact that you might issue a statement saying you thought that the amount they set aside was inadequate; would not that be a pretty effective tool for you to use, given the again sophisticated nature of the consumer?

Mr. FERGUSON. That would be a dramatic change in the relationship. One of the things that happens in supervisory relationships is that by and large, unless an institution goes to the point that we need to have a public memorandum of understanding or a cease and desist order, we keep confidential the regulatory information. For example, we do not publish the so-called CAMEL rating. So to move into a position where in lieu of using Pillar I we are in a name-and-shame mode, a whistleblowing mode, changes the confidential relationship that we normally have with institutions. I would prefer not to do that for the sake of operational risk.

I think this Pillar I approach allows the right kind of discussion and the right kind of transparency, without putting us in the awkward position of disclosing confidential information about how we consider banks in terms of, if you will, a rating. That is the implication of what you just said, and it is quite a change from the way that we normally deal with banks. I do not think you really want us to go down that path.

Mr. FRANK. No, my feeling is that the fact that you might do it would give you as much leverage as you needed.

Mr. FERGUSON. Yes, but what I have said is that the reality is that the banks know that historically we have not done that, and in fact we are by our own rules and regulations—

Mr. FRANK. You historically have not given them a charge for this kind of risk, either. The whole purpose of this is to change the history.

Mr. FERGUSON. Let me respond to your other question, which is whether or not sophisticated counter-parties would have a general sense. The answer is that even for sophisticated counter-parties, they may have a general sense of management, but in fact they really cannot look into these opaque institutions with the same clarity that the management itself has, and indeed in many cases the management itself uses. One of the things that you must understand is that Pillar I, or this entire approach, so-called advanced measurement approach, depends on the bank's management measurement tools with respect to operational risk. In some situations, we are leveraging their strengths and their internal view to develop capital, as opposed to only on externals.

Mr. FRANK. That is another question. If the bank does not have good internal management, then Pillar I is not going to work so well with them?

Mr. FERGUSON. No. The point of Pillar I, and using all three Pillars in this case, is to provide the banks with the right set of incentives to manage as we know the leading edge banks can do, and as we know many of the other large banks are starting to do already, which is not; while it is a relatively nascent science to compare their credit risk, this is not something which the people on panel two or any other leader of one of the major banks has a complete lack of experience or exposure. So we are trying to give them the incentive to keep going down a path that we, and I would think they, should be on.

Mr. FRANK. I appreciate it. I have taken too much time. I have some other questions, but I will submit them.

Chairwoman BIGGERT. We will have another round.

Let me ask the next question, and I will direct it to the other two gentlemen, although it really does apply to all three of you, but we can come back to that. I really do not want the answer; it is a question that is similar, but there are other things in here that I would like you to address, rather than what has just been talked about.

It is my understanding that the operational risk will include a charge for the potential costs associated with U.S. tort liability, discrimination, suitability and similar laws, most of which do not apply in the European Union or in Japan. Would not such a capital charge have an adverse competitive impact on U.S. banks, and perhaps reduce compliance efforts? I wonder if you could give the subcommittee any examples of where the costs associated with compliance or litigation have resulted in a bank failure. If not, why impose a capital charge related to them? Would more effective supervision then enhance both the social policy goals of these rules and reduce the operational risk?

Mr. Hawke?

Mr. HAWKE. I am frequently asked the question about whether operational risk events have resulted in bank failures. One has to scramble to try to find examples of that. There are probably one or two, but there is no question that operational risk events have resulted in significant loss. I do not think the test of failure is necessarily the right one.

Differences between the United States and foreign countries, in things like tort liability may well exist, reflecting differences in risk between banks operating in those jurisdictions. If our banks are subjected to greater potential risk because we have a more refined system of tort liability, that is a real risk that they face. It may indeed result in some kind of competitive inequality.

Chairwoman BIGGERT. Mr. Powell, do you have anything to add?

Mr. POWELL. I would not have anything to add except this. While Comptroller Hawke indicated that he is not sure that should be the test as it relates to operational risk, I would agree with him. We would be hard-pressed to find that institutions have failed on a regular basis because of operational risk. Some of these operational risks are insurable. One can purchase insurance for that risk.

Having said that, clearly operational risk is very real in the marketplace, and capital should be allocated. We at the FDIC believe that there should be supervisory flexibility in addressing operational risk. As we indicated, we really have no preference whether it is in Pillar I or Pillar II.

Chairwoman BIGGERT. Then saying that, is there any flexibility in Pillar I for operational risk?

Mr. HAWKE. Madam Chairwoman, I think the important thing to understand about operational risk is that there are at least three components that need to be addressed in assessing it. One is the nature of the risk; another is the quality of the controls that the bank has to address the potential risk. The third would be the quantification of that risk and the translation of that quantity into some kind of capital charge.

All those things would have to be done whether this was nominally under Pillar II or Pillar I. I have argued in the Committee consistently that this should be a Pillar II exercise because so much of it is subjective in nature: the evaluation of internal controls, the evaluation of the nature of the risk. But ultimately, it comes down to a question of quantification and determining how much capital should be held against those risks.

I think that the advanced measurement approach that we have developed, which is nominally a Pillar I approach, takes into account an appropriate degree of subjectivity. It is still a work in progress. We still have to make sure that it works right, that we are approaching the quantification issue, and the capital charge that results, in an appropriate way. But from my point of view, the good thing about the AMA approach is that it infuses a substantial amount of supervisory discretion into the process, the same kind of supervisory discretion we would have had if this had been under Pillar II.

Chairwoman BIGGERT. Thank you. My time has expired. The gentlewoman from New York?

Mrs. MALONEY OF NEW YORK. Thank you.

Earlier I wrote Comptroller Hawke and others about my concern about the global competitive nature of the financial services industry, and the concern that American institutions not be placed at a disadvantage. He wrote back, and I would like to place both letters in the record, and expressed some of the testimony that he is giving today on the Pillar I versus Pillar II, for the charge or operational risk. He has testified that the advanced measurement approach appears to add more flexibility. I would like to put his letter in the record. I think it is very clarifying and important.

Chairwoman BIGGERT. Without objection.

[The following information can be found on page 171 through 173 in the appendix.]

Mrs. MALONEY OF NEW YORK. I would like to follow up on what you are saying on how in the world do you resolve the differences when you have a disagreement, as you have expressed today, between Pillar I and Pillar II, for the charge for operational risk? When we get to rulemaking, there will be differences of opinion, and the OCC has oversight for national banks, the Fed for holding companies; if you disagree, how do you resolve it? Who has the final trump card?

Mr. HAWKE. We spend a great deal of time trying to work out interagency differences. I think that effort has been enormously successful. We have common objectives and have worked very well together. I do not anticipate that that will change going forward.

As I mentioned in my testimony, the OCC has the sole statutory responsibility for determining capital requirements for national banks. In the theoretical event that we do not come to closure with our colleagues at the Federal Reserve on an approach, national banks would be subject to whatever regulatory requirements we imposed on them. The Federal Reserve has authority to set the capital requirements for holding companies and non-bank subsidiaries of holding companies, but that ability to set holding company capital is not intended to supplant the judgment or authority of the primary supervisor with respect to the banks. Holding company capital is intended to protect the bank from the holding company, not to protect the holding company from the bank.

I think our respective roles are pretty well spelled out by statute, but I do not anticipate that if this process works the way it should that we will end up having significant differences.

Mrs. MALONEY OF NEW YORK. Comptroller Hawke, why is a capital charge being proposed for operational risk when there is no comparable one for interest rate risk? While significant problems remain quantifying and measuring operational risk, many of which you have pointed out today with your colleagues, interest rate risk is priced daily by well-understood methodologies. So why omit interest rate risk from Pillar I, when it has been the cause of bank failures, while subjecting operational risk to it? Why are we taking that away from Pillar I when we know there have been bank failures, and you testified you do not even know if there have been bank failures in operational risk.

Mr. HAWKE. That is a question that got raised and negotiated very early in the Basel discussions. There were a number of us in the U.S. delegation who felt that interest rate risk ought to be included in Pillar II. As I said, I felt that operational risk ought to be included there as well. In early negotiations in the Basel Committee, it was agreed that interest rate risk would be treated as a Pillar II item, with attention focused on outliers in the spectrum of interest rate risk.

Mrs. MALONEY OF NEW YORK. Why shouldn't it be in Pillar I?

Mr. HAWKE. I think one can make an argument that it should be in Pillar I. It is probably easier to quantify.

Mrs. MALONEY OF NEW YORK. Much easier to quantify than operational. So why is it not in Pillar I versus operational?

Mr. HAWKE. Interest rate risk is a lot easier to deal with. banks deal with it all the time. The concern with respect to interest rate risk was not the run-of-the-mill kind of risk, but the risk presented by outliers who have significant mis-matches and different kinds of portfolios. It was thought that there was more room for supervisory discretion.

Mrs. MALONEY OF NEW YORK. So the United States more or less wanted it in Pillar I, and the foreign countries did not; is that it?

Mr. HAWKE. No, the other way around. We wanted it in Pillar II.

Mrs. MALONEY OF NEW YORK. You wanted it in Pillar II?

Mr. HAWKE. That was one that we won.

Mrs. MALONEY OF NEW YORK. You won that one. Okay.

One of the things that I am concerned about, and this is something that the ranking member mentioned and the chairman mentioned, and everybody on the panel both sides have mentioned our concern about how are we looking out for financial institutions, American banks, to make sure they are not placed at a competitive disadvantage? I would like to hear from all of you. What are you doing to make sure that we are not placed at competitive disadvantage? I can see a lot of things in this that could hinder the competitive ability of our banks. So I would want to know, do you have a formal procedure where you make sure that we are not in any way hindering American banks in the competitive market here or place unfair charges and burdens on them?

Chairwoman BIGGERT. Briefly, please.

Mr. HAWKE. Let me say that the very purpose of Basel II was to try to improve competitive equality among internationally active banks since it was felt that Basel I left too much room for competitive inequalities to emerge. So in terms of competition and competitive equity among internationally active banks, that has been the name of the game. As I said, I think that some issues, like the very complexity of the process itself or the rule itself, work toward competitive inequity because of the differences in the nature of the supervisory systems between countries.

Mr. FERGUSON. If I may address that issue as well, a couple of things. One is, I believe that the strength of the U.S. banking system deals with the fact that we have very strong capital, among other things. If you compare the U.S. banking system to that in Europe and certainly in Japan, I see no competitive weakness at all in the U.S. by having strong capital. I think just the opposite.

Second point, as my friend Jerry Hawke has pointed out, the name of the game here and the reason to have these three Pillars and to have transparency et cetera is to allow greater competitive comparisons across institutions. That is one of the reasons why we have entered into this, so as to reduce competitive inequity.

The third is we clearly have in a number of places decisions that a bank from wherever they may be operating in the U.S. will be required to live by some of the elements of the accord that we are developing here as part of national discretion. So we have managed with this head-to-head competition in some of these various portfolios to confront the issue directly.

I think we should not make the mistake of believing that having strong, well-capitalized banks with strong risk management weakens them in a competitive sense, because the recent history and long history indicates that the U.S. banking system is extraordinarily competitive vis-a-vis many others who have, frankly, exercised a lot more forbearance than we have. So I think the strength of our system comes from just the kind of regulation and the kinds of controls that we are discussing here today.

Mrs. MALONEY OF NEW YORK. My time is up.

Chairwoman BIGGERT. Mr. Kennedy, the gentleman from Minnesota.

Mr. KENNEDY. Thank you, and thank you, panel, for your testimony. I would just like to continue on that dialogue on competitive-

ness. I will grant you that we have the world's best banks and the world's best regulators, but when I look at that, how do I make sure, and does Basel II make us more likely to have uniformly applied regulations among the regulatory bodies in other countries? You talk about this, how it gives you more flexibility. Well, flexibility gives me concern if that means that the other regulators in other countries do not apply the same levels of standards that we do, that we put in that way American banks at a competitive disadvantage.

Mr. FERGUSON. I think there are three components to my answer to your question. First, it goes back to the differences between Pillar I and Pillar II, et cetera, where indeed Pillar II is by definition one that creates more of a negotiation. It is less transparent, and therefore there is more regulatory discretion. Consequently, the need to put things such as operational risk, I believe, in Pillar I where there is a more rigorous framework, yes, built around internal management and measurement approaches, but with a more rigorous framework and more rigorous outline, point one.

Point two, is there are three Pillars here. One of them has to do with transparency. One of the best ways I believe to ensure the kind of international equality that you are discussing is to have the banks that are under Basel II or will be under Basel II required to disclose important parameters, not the ones that are of competitive sensitivity per se, but the ones that allow best comparisons across institutions in terms of the nature of their portfolios, the nature of their risk management capabilities so the counter-parties can look and understand a bit more about them.

The third is that there is a structured process among the members of Basel II, of the Basel Committee. There is an accord implementation group that brings the regulators together to hold each other accountable for how this is being implemented. So that if we from the U.S. standpoint have a strong sense that some of our colleagues around the world appear not to be bringing the same focus, the same seriousness, we have this infrastructure, this communication technique through the so-called AIG, the Accord Implementation Group, that allows us to pressure them and to encourage them to take the same approaches that we are.

I think those three tools allow for a stronger sense of competitive equity, and a real sense of checks and balances in this process.

Mr. HAWKE. I would endorse the points that Roger made, and add one further point that continues to trouble me in the area of competitive equity: that is, the vast differences in the nature of supervision. As I said in my testimony, we have in our largest national banks 30 or 40 full-time on-site examiners. We are intimately involved with those banks. In banks in some other countries, an outside auditor may do a flyover once a year. There is a significant difference in the invasiveness, if you will, of supervision between the United States and other countries. Given that disparity, it is inevitable, no matter how good the mechanisms are that the vice chairman described, it is inevitable that there are going to be disparities in application. The complexity of the proposal adds to that potential.

Mr. POWELL. I would just add one comment. We have been talking a lot about the international anti-competitiveness. I think it is

important for us also to pause and think about the domestic competitive inequities, if they are in fact are there. That is the reason I think some of the issues that we will be talking about as we go forward will come out in the public comments. I, too, am concerned about regional banks and smaller institutions that might be disadvantaged by Basel II.

Chairwoman BIGGERT. Thank you.

Mr. KENNEDY. I would share that concern. I would just like to follow up. Your discussions of the regional concerns are shared with me when you have two different standards within the same country. But following up on the international side, in my years as chief financial officer, we would note significantly different responsiveness from a Japanese-style bank versus an American bank. One of my big concerns is the fact that the hangover from that period where we had excessive bad loans in the Asian countries that have not been written off; is this new accord going to help bring our Asian counterparts towards addressing those issues? Or do we have to look for other avenues to try to encourage that?

Mr. FERGUSON. I think that is again a serious question. One would hope that if this is indeed enforced, and if again the public disclosure part as well as the regulatory part forces banks around the world, including Japanese banks, to use these more sophisticated risk management techniques, that you will find less of this irrational pricing that you have talked about. One of the points that I have made often in discussions is that the international banks, particularly the U.S. banks, need not worry so much about strong regulation from the Fed or the OCC or the FDIC, as they need to worry about irrational pricing from competitors who do not have the same sophisticated approach to risk management capabilities as embedded in Basel II. So that hopefully would respond to some of your questions.

If I could take one minute to respond to the question about domestic competitiveness, I think that is an issue that must be explored in the comment period. However, as I have said in my written testimony, there are a couple of reasons why I guess I have a little less concern than my colleague from the FDIC, Mr. Powell. The first is that smaller banks tend to have much more information about their local counter-parties than a large national bank that is not actively in that market. The large national banks tend to depend much more on models and the information that can run through models. We have not seen any sense in which small banks are at a competitive disadvantage today. They clearly have shown a great deal of strength because of their understanding of local market conditions.

With respect to regional banks, the capital that matters is not the regulatory capital which we are talking about here, which is a minimum capital. It is economic capital. There is nothing in Basel that is going to change economic capital. It is going to make things more transparent, but not change the economic capital that is the factor that decides pricing. In places where economic capital, which by and large tends to be higher than regulatory, that will certainly be the case. In those few cases where economic capital is lower than regulatory capital, which is to say you have new techniques that have developed such as securitization, which clearly is an im-

portant part of the U.S. market, that already exists. Both larger banks and regional banks are both using these securitization mechanisms to maintain a relatively level playing field where regulatory capital was set too high and therefore there are new techniques.

So I would argue even in the domestic situation, while it is important to ask the question, as we will when we get into the ANPR process, the proposed rulemaking process, I see nothing here that immediately leads me to believe that the competitive status quo is going to be changed domestically because of these capital changes. There are a number of other reasons that I have given in my written testimony to deal with the competitive issue as well.

Chairwoman BIGGERT. The gentleman's time has expired. The gentleman from Illinois, Mr. Emanuel is recognized for five minutes.

Mr. EMANUEL. Thank you very much. Thank you for coming today.

Obviously, since the decade and a half since the first Basel accord, it only makes sense to review, update and change given how much the marketplace has changed, and given that the first set of rules dealt with uniformity in the international market and tried to bring some safe and sound banking rules across borders and across markets. Although a lot of the questions have dealt with international competitiveness for American charter banks in the international market, I want to deal a little or ask some questions as it relates to how some of these rule changes have on a credit crunch. A lot of these discussions, as our ranking member made sense, you do not get questions like this about the Basel accord at town halls, which is true. You do get questions from a lot of folks about the notion that they cannot get access to capital at the very time they need capital. Some of the capital requirements here that have been discussed and recommended, my worry is they would actually have an adverse affect at the time in which you need capital, you cannot get it; at the time you do not need capital, you have access to it.

So I would like to change just one; some of the rules and some of the suggestions here, the 20 percent operational risk capital charge, that also impact; it is also suggested that the flexible system that results in banks holding more capital in bad times and less capital in good times may adversely affect the economy by decreasing credit availability when it is needed most. I wanted to ask, as you go through the rulemaking process, what are some of the potential unintended consequences of new capital requirements as it relates to the flexibility that you are going to now ask for in the system, as it relates to the capital crunch in these times, whether the inverse effect?

In any order, go ahead.

Mr. FERGUSON. I will respond first, and I am sure my colleagues will have other things to say as well.

Obviously, we have been aware of the concern about cyclical implications with respect to Basel II. I have three or four components to my response. First is, I believe and I think we all collectively believe, that if you have a risk management system that is more risk sensitive, then what it will allow is for banks to make, and that sensitivity being measured over an entire cycle; I will not go

through the technical reasons, but Basel II allows for that to be measured over an entire business cycle, not just in a short term-what you will find is that loan pricing is better. It reflects the risk. Therefore, what you will find is you have less of a tendency to make unreasonable loans during good times, and consequently are less surprised when loans fall off and profitability falls off in bad times. So there is a possibility that if you have much better risk management techniques and that plays through to better pricing, that you will get less of a cyclical swing, instead of more.

The other point I would make is that we, being quite aware of some of these concerns, have also made a number of refinements and adjustments to allow for some of the measurements that the banks have to put in to again be less focused on a point in time in the cycle, and instead extend it out over a longer period of time. I will not try to go into all the technical details here, but we have been aware of that and have taken that on board.

I would also say that one of the important changes under Basel II is that Basel I does not give banks credit for a number of things that matter and help to offset risk, that we plan to put into Basel II. For example, the current accord does not give any capital credit when collateral or other methods are taken to reduce risk and reduce the possibility of a loss given default. So that should also work to mitigate the possibility of having this be pro-cyclical. We will again continue to look at this as one goes into the comment period. I am aware of the comment, but I think the Basel Committee and the staff that support it, having heard the comment, have already undertaken two or three different efforts to reduce the risk of pro-cyclicality.

The other point I would really have to make is indeed I would think when times get bad, it is important for banks to take that on board and to recognize, as they have during every slow period, that it is appropriate to tighten credit to some degree; not to create a credit crunch, but to tighten credit to some degree. Most of the times when we have seen credit crunches occur historically, it is because there is a sudden and unexpected loss in profitability that has the risk of eating into capital. If we have gotten this right, we will find that you have fewer of those incidents occurring going forward.

So I am aware of the procyclicality argument, but I think there have been a number of efforts made here to refine this, to minimize that kind of risk, and indeed to make this, if you will, a tool that allows good bankers to be better bankers during both the good times and also the bad times.

Mr. HAWKE. Let me just answer briefly, unless you had another question. As a bank supervisor, not a central banker, I get a little bit nervous talking about procyclicality in the context of determining what the appropriate capital rules are for banks. I think that the best thing we can do to avoid a credit crunch is to make sure that our banks stay in sufficiently healthy condition to be able to make creditworthy loans when the opportunity arises, irrespective of what is happening in the economy. I think once we get into the business of trying to manipulate the capital rules to take account of changes in the macroeconomy, we run the risk of subverting the banking system to broader, perfectly legitimate con-

cerns, but with the potential for effects that we see in some other countries where banking systems have been manipulated, where banking systems have become a disaster and have not been able to help in the recovery.

So this is an area that I think we have to approach with great caution. As I say, my inclination as a bank supervisor is to look at capital rules without getting too concerned about procyclicality.

Mr. POWELL. I would tend to agree with Comptroller Hawke. I think the best defense against a credit crunch is a solid banking system. You build up capital in good times so that you can use it in bad times. I think there is a tendency for all bankers during nad times to impose additional requirements when we extend credit. But if in fact you have a healthy banking system, there is always going to be available credit.

Chairwoman BIGGERT. The gentleman yields back. The gentlelady from California, Ms. Lee.

Ms. LEE. Thank you, Madam Chair.

Let me first thank the witnesses for your testimony and your presentations. I would like to ask all three of you just to give us some feedback with regard to Basel II as it relates to the real estate market. Some have said that it could negatively and adversely affect the U.S. real estate market. One, credit reallocations could adversely affect real estate development. Secondly, higher capital charges could result, well, would result in banks being forced to tighten their lending requirements, which of course then means that loans to anyone other than the highest rated would require banks to increase their capital services. So if banks were forced to retain more capital, it would be hard, I assume, to maintain some banks' current lending activities, with certain customers with lower credit ratings.

Finally, I think one of the problems that many are raising with regard to the impact of Basel II on real estate development is that there would be fewer resources to purchase real estate loans from originators such as banks, leading to the tightening of credit in real estate markets. I would just like to get your feedback on those points, if in fact you see that as a problem or if in fact there are ways that it really is not a problem as you see it, with regard to Basel II.

Mr. HAWKE. Let me take a crack at that. I think the Basel Committee has been very sensitive to the potential for inadvertent credit allocation as a result of what we are doing. One of the problems with the existing Accord is that the risk weight buckets that are used are so inexact in their determinations of risk that they do create opportunities to arbitrage the capital rules and that does have an effect on how bank credit is allocated.

On real estate specifically, we have an ongoing dialogue at present as to whether the approach to commercial real estate lending is the right one. Commercial real estate lending is not something that has been looked on in Washington with great favor because it lay at the heart of many of the bank failures in the late 1980s and early 1990s. The state of the art of commercial real estate lending has changed quite significantly since then. While there is an understandable skepticism and concern about the inherent safety of commercial real estate lending, we are inclined to think

that we might not have to be as tough on that as the experience of a decade or more ago might suggest.

Mr. FERGUSON. If I may respond to this as well, I think that Jerry Hawke is absolutely right in suggesting that the way to maintain healthy bank relationships in the context of real estate lending is to create, again, a system in which they really evaluate their risks appropriately and lend the right amount at the right price. No country is benefited by having excessive lending to any one sector, for sure. If Basel II works well, or any new capital approach works well, then what you will find is that indeed you have got a much better allocation of capital and that is what we want.

Ms. LEE. But with customers with lower credit ratings?

Mr. FERGUSON. That is the same issue. There is no different answer there. We have benefited in this country from the use of a number of new techniques that allow customers with lower credit ratings that have still good assets to get loans from banks. There is nothing that I see in Basel II that would put that at risk. I would think Basel II would encourage better pricing, for sure, which is again to everyone's benefit. There are other rules that obviously should deal with disclosure and transparency, et cetera. So I do not see any specific reason to worry about customers with the lower rating in some sense not getting the appropriate allocation at the appropriate price with respect to capital from Basel II.

Mr. FRANK. Will the gentlewoman yield?

Ms. LEE. Yes.

Mr. FRANK. A brief question; one of the things that strikes me, we have the three different agencies. Is the Fed the controlling agency here regarding America's position, and is that automatic because it is through Basel. If not, who decided this? How did we get to the point where it is the impression it has been the Fed's opinion that has governed. Why is that the case and is that something that; how does that happen?

Mr. HAWKE. Congressman Frank, I have been sitting on the Basel Committee for four years, and I still do not understand how decisions are made. They appear to—

Mr. FRANK. Well, is it automatic because it is central bankers? Did the president at some point designate a lead agency? How does this happen?

Mr. HAWKE. There are four U.S. agencies that participate: the three of us and the Federal Reserve Bank of New York.

Mr. FRANK. The Federal Reserve of New York is for these purposes the equivalent of the national agencies?

Mr. HAWKE. Yes.

Mr. FRANK. That is kind of like giving the Ukraine two votes, and Byelorussia votes at the United Nations, in 1945.

[Laughter]

Mr. FERGUSON. Perhaps I should respond to this.

Mr. HAWKE. I am not going to touch that one.

Mr. FERGUSON. Congressman Frank, the way this works is there are tough negotiations that occur among the three agencies. The people at this table get into negotiation. The people sitting behind us get into even more heated negotiations to try to develop a U.S. perspective. There is no lead agency here.

Mr. FRANK. Okay. Suppose there is a division, does the president ever decide?

Mr. FERGUSON. No.

Mr. FRANK. I have imposed on the committee's time, but this is one of the procedural things I think we ought to be straightening out. When we are talking about narrow technical things, it is one thing, but it does seem to me we probably ought to have some—

Mr. FERGUSON. But there is no difference in this area, I would argue, than in any other area of regulation. The OCC has pointed out clearly that they have lead responsibility.

Mr. FRANK. I differ with you, Mr. Ferguson, because each of you is supreme in his area of which bank, that you have certain basic things. But when we talk about an American negotiating position with other nations, it does seem to me we ought to have some more clarity as to who decides what that negotiating position is. Right now, apparently we do not.

Mr. FERGUSON. The Basel Committee has historically been a committee that has brought regulators together to try to determine what we think is the best approach to regulations.

Mr. FRANK. Right, but it does seem to me we ought to have somebody ready to make a decision.

Mr. FERGUSON. Well, that is in part one of the reasons that we negotiate, obviously, is to make sure that we can come to you and give you our best advice. Clearly, one of the reasons in a democracy is that you have a comment period when you do—

Mr. FRANK. Yes, but you also have somebody who finally—

Mr. FERGUSON. And we have this kind of discussions to do that.

Mr. FRANK. I think this is something the committee will have to look into.

Chairwoman BIGGERT. The gentlelady's time has expired. Let us do one more round. We do have another panel, but if we can ask succinct questions and get succinct answers, we can do another quick round. So I will start with a question.

There is the extensive comment period for this proposal and for any rules that are coupled with several years of data collection. Do you think that the time frame for implementation of Basel II is a little unrealistic? It seems to me that the time frame assumes that there will not be a need for a fourth consultative paper. Is this a foregone conclusion?

Mr. HAWKE. Not in my view, Madam Chairwoman. I think that the domestic rulemaking proceeding that we are going to be embarking on in the near future must be a fully credible and reasoned process that has integrity to it. That means that if we get comments back in that process from all sorts of potential commenters who have not yet had a chance to swing in on Basel, we have got to take them into account and evaluate them. That means that if our collective judgment is that there needs to be a fix, we have to either go back to Basel or let our colleagues on the Basel Committee know that there is going to be a U.S. exception on whatever the particular issue is.

Chairwoman BIGGERT. Thank you. Mr. Powell?

Mr. POWELL. I agree with the Comptroller.

Chairwoman BIGGERT. Thank you for your short answer.

Mr. FERGUSON. I agree as well.

Chairwoman BIGGERT. Dr. Ferguson?

Mr. FERGUSON. I agree. You got two short answers in a row.

Chairwoman BIGGERT. The Federal Reserve recently issued a white paper on infrastructure security in which it calls for U.S. domestic financial institutions to increase expenditures on infrastructure protection. This, coupled with the fact that the Basel II proposal calls for a mandatory operational risk charge troubles me. It seems like the Fed is requiring domestic financial institutions to pay twice; once for improvements in the infrastructure and once for a capital charge. Can you explain for me why these seemingly divergent policies are coming from the Fed?

Mr. FERGUSON. I do not think they are all divergent. I think they are actually quite consistent. Let me be pretty clear about two things. One is there have been failures due to operational risk. Secondly, the Fed as the lender of last resort has had the largest single discount window loan ever because of an operational failure. It was $20 billion. It happened many years ago, but on a daily basis we have institutions that because of operational failure borrow from us during the course of the day. It is called a daylight overdraft.

Thirdly, obviously as you well know, one of the recent times I was here was post-September 11, in which we lent several hundred billion dollars or over $100 billion. So we take operational risk quite seriously.

Fourthly, there is nothing inconsistent about the two activities that you just alluded to. The point of the white paper is to encourage institutions to build appropriate backup capability so they can be more resilient, and so the financial markets can be more resilient. The point of Basel II is to say because these things may occur even if you are resilient, it is important to have capital. The way Basel II will work is that if a bank has managed its operations so that it has reduced some of the kinds of risks that we are concerned about under Basel II and operational risk, then that will come into play because the amount of capital they will be expected to hold will be lower. There will be offsets, for example, for insurance as well. So the two things I would say in lieu of being contradictory are much more hand-in-glove. They are really quite complementary.

Chairwoman BIGGERT. And you do not believe that there is a pay twice?

Mr. FERGUSON. No, I do not believe there is a pay twice.

Chairwoman BIGGERT. Okay. Ms. Maloney, do you have another question?

Mrs. MALONEY OF NEW YORK. Yes, I have a short question for Vice Chairman Ferguson. As you know, I have had a long interest in the Fed's role in the payment system. Federal law requires the Federal Reserve Board to calculate a private sector adjustment factor, a PSAF, to ensure that it is not competing at an undue advantage with private providers of payment services. How will the Fed adjust the PSAF for the operational risk capital charge banks will have to hold if the current version of Basel II is imposed?

Mr. FERGUSON. I cannot give you a specific answer. I can tell you in general how we think about this. We have in our system layers of backup that are similar to those that are expected in the private

sector. In fact, I would argue that we have deeper backup than any private sector institution because obviously we have 12 institutions around the country and we work well together.

One of the issues that is considered in the PSAF, as you know Congresswoman Maloney, is in fact questions of equity and what the equivalent equity in capital would be in the private sector. So obviously, we will consider that as we go forward. But let me reiterate the point I made earlier. I do not expect any bank to have an increase in the amount of capital being held because of this operational risk charge. There may be greater transparency. As Congressman Frank once said in another context, it is really moving capital from one drawer to another, from looking as though it is excess to being obviously associated with operational risk. That does not mean that the base of capital overall is going to go up, so I am not really sure that since there will be I do not believe brand new incremental capital in the banking system because of an explicit charge for operational risk, that we should have to change the PSAF. If that is the case, we will obviously adjust the PSAF so we stay in compliance with the Monetary Control Act.

Mrs. MALONEY OF NEW YORK. I would like to follow up with Ranking Member Frank's question. Actually, I asked the same question earlier. How do you resolve differences? If you get back to us in writing. I have heard two descriptions of how you resolve it, and I am still not clear, so possibly if you could get back to us in writing.

Very briefly, Vice Chairman Ferguson, I want to ask the same question actually I asked earlier. What is the necessity for a minimum capital charge or Pillar I treatment for operational risk, while you are not; why admit to interest rate risk from Pillar I when it has really been the cause of more bank failures, while subjecting operational risk to it. I do not understand why they are treated differently when interest rate risk is easier; there is a methodology that everyone understands and there are more bank failures from it. Why is that not getting Pillar I treatment?

Mr. FERGUSON. One of the things you have to understand is what the banks themselves do. banks themselves do operational risk as very large. We have taken a survey and we found that somewhere between 10 and as high as 15 percent of economic capital, which is not this minimum, but the economic capital that they hold, they often ascribe to operational risk. That is a significant sign that the banks themselves see operational risk as a real risk. We believe that implies and deserves treatment as this credit risk in Pillars I, II and III.

The second point I would make is that banks actively manage interest rate risk on a daily basis. There are large committees called asset liability committees whose job it is to manage interest rate risk. What we have found over history is that they do a pretty good job of that. They are not perfect, and the reason that we, the U.S., have taken a consistent point of view that interest rate risk should be under Pillar II is that we have found that our discussions with them about how they manage interest rate risk under Pillar II has been quite sufficient in keeping that appropriately under control, and the banks understand that as well.

So this is an area where in some sense things have worked reasonably well, and we believe that the status quo seems to be the best approach. That is sort of the whole goal of these various internal models, et cetera, that banks have. So I think you should think of these two things as being slightly different, and the approach to management being slightly different. Frankly, the incentives that are required are also slightly different, which is one of the ways I think op risk is very much like credit risk and deserves treatment across all three pillars.

Mrs. MALONEY OF NEW YORK. I want to clarify my position, that I do not think that operational risk should be under Pillar I, but I appreciate your, or interest rate, for that matter. Would you like to; everyone has commented on it, would you like to comment on it too, Mr. Powell?

Mr. POWELL. The FDIC position is we are not concerned with whether it is in Pillar I or II. We have no preference there.

Mrs. MALONEY OF NEW YORK. Okay. Thank you very much. My time is up.

Chairwoman BIGGERT. Thank you. The gentleman from Massachusetts is recognized for five minutes.

Mr. FRANK. Mr. Powell, you just said that the FDIC has no position on whether it should be Pillar I or Pillar II?

Mr. POWELL. Right.

Mr. FRANK. Mr. Hawke, does the comptroller of the currency have a position on whether it should be Pillar I or Pillar II?

Mr. HAWKE. As I said, we have argued until we are blue in the face that it should be a Pillar II requirement.

Mr. FRANK. Well, I am back to governance. Okay, I appreciate that. Okay, we have got four; first of all, I have to tell you, Mr. Ferguson, this is a profound issue for me. You three are appointed by the President of the United States and confirmed by the United States Senate. The New York Fed, as capable a technical institution as it is, is, as are all the regional banks, a self-perpetuating institution with no democratic involvement in the appointment of the head.

Now, what we have is this, the four members; one prefers Pillar II, one is indifferent, and we have a strong national position in favor of Pillar I. I think the governance here is awry. How did this happen?

Mr. HAWKE. I would not say that we have a strong national position in favor of Pillar I, Congressman Frank. The Basel Committee as a whole has taken that position.

Mr. FRANK. The Basel Committee of the United States?

Mr. HAWKE. No, the Basel Committee in Basel.

Mr. FRANK. Okay. But what about in the United States? I certainly got the impression that the United States position was strongly for Pillar I.

Mr. FERGUSON. I think where we are on this is that we believe, all of us, and I know Jerry will speak for himself, but I think what I have heard him say is he has argued many times for Pillar II. There was not a consensus. Pillar I with this AMA approach seems to be a reasonable place to end up.

Mr. FRANK. To whom?

Mr. FERGUSON. I think to us.

Mr. FRANK. Not to the FDIC, which is indifferent.

Mr. FERGUSON. As I said congressman, Jerry will speak for himself.

Mr. FRANK. He just did. He said he argued.

Mr. FERGUSON. Pillar I is a reasonable place to end up.

Mr. FRANK. Look, it is okay to have a position, but I do not think you are being totally straightforward about this. The FDIC did not have a position on Pillar I or Pillar II. The OCC was for Pillar II. And we wound up with Pillar I as a consensus. This is some consensus. I would like the power to impose such a consensus. I think clearly the Fed has become de facto the lead agency, maybe because we are dealing with international entities. I have to tell you, I think this requires some further thought on our process. To the extent that we are talking about fairly technical issues, that is one thing. For instance, one of the examples we are dealing with here; both my colleagues from California, Mr. Baca and Ms. Lee, raised small bank-big bank issues. To be honest, I think most people would rather have the FDIC and the OCC dealing with the small bank big bank issue than the New York Fed as an equal. I think these are legitimate governance issues that we have to raise.

Nothing further for me. Mr. Ferguson, I will; oh yes, Mr. Powell.

Mr. POWELL. Congressman, I want to be sure that I am clear with you. While we do not have a preference whether this should be in Pillar I or Pillar II, we stress the need for supervisory flexibility in the implementation of it.

Mr. FRANK. I appreciate that, and I think that frankly goes more for where we are, not where we were.

Mr. POWELL. Right. I agree.

Mr. FRANK. Yes, Mr. Hawke.

Mr. HAWKE. I want to make clear that I support the AMA approach, even though I would strongly prefer Pillar II.

Mr. FRANK. I understand that. You are no longer blue in the face, but you used to be, and I do think that goes to how we got there.

Mr. Ferguson, just so that people do not think I am being entirely anti-Fed, I will refrain from asking you what you think about the President's tax plan. And I have no further questions.

[Laughter]

Chairwoman BIGGERT. The gentleman yields back. This will conclude the first panel. Thank you, gentlemen, so much for coming, and your expertise.

The chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses, and to place their responses in the record.

We will now proceed with the second panel. If they could come forward and take their seats as quickly as possible, please.

I would like to welcome the second panel First we have Karen Shaw Petrou, the co-founder and managing partner of Federal Financial Analytics, a privately held company that specializes in information and consulting services for financial institutions. Ms. Petrou spent nine years at Bank of America as an officer in their San Francisco headquarters, and then in Washington as the rep-

resentative of the bank on Capitol Hill, and before regulatory agencies prior to starting Federal Financial Analytics.

Mr. Frank, did you want to introduce Mr. Spina?

Mr. FRANK. Yes, I am very pleased that we are joined by David Spina, who is the chairman and chief executive officer of the State Street Corporation, which is Boston-based, actually headquartered in the district of my colleague Mr. Lynch who has joined us. He has been at State Street since 1969 and has had obviously a variety of positions there. He became CEO in 2000 and chairman in 2001. I am impressed when I read the information. I am impressed by two things, one that State Street was cited by Working Woman magazine as one of the top 25 companies for executive women, but even more important that Mr. Spina chose to put this in his biography. Frankly, he is a man of many accomplishments, in a wide range of things. I would note that he manages to expand two cultures. His undergraduate is from Holy Cross and his M.B.A. from Harvard, so he has a certain cross-cultural aspect. I do want to commend State Street also for its ranking from Working Women magazine and for singling it out, and for calling our attention for what seems to me a very significant issue. Thank you, Madam Chair.

Chairwoman BIGGERT. Thank you. Next we have D. Wilson Ervin, who is managing director of Credit Suisse First Boston and head of risk management. He is a member of CSFB's risk committee and the leadership and performance committee. He joined CSFB in 1982 and has been involved in fixed income and equity capital markets, the Australian investment banking team, and the mergers and acquisitions group. Mr. Ervin received his B.A. in economics from Princeton University.

Finally, we have Ms. Sarah Moore, executive vice president and chief operations officer of the Colonial Bank Group. She is a certified public accountant and worked for Coopers and Lybrand for nine years prior to her career with Colonial. She is a graduate of Auburn University with a B.S. in accounting.

Just so that Mr. Spina will not feel left out about his college credentials, he has a B.S. degree from the College of Holy Cross and an M.B.A. degree from Harvard University, and was an officer in the United States Navy and served a tour of duty in Vietnam.

We are pleased to have this panel. As with the prior panel, if each of you could hold your comments to five minutes, and then we will have questions following that, and we usually get to any of the testimony that you did not get around to giving when you gave your testimony.

Ms. Petrou, if you would proceed.

STATEMENT OF KAREN SHAW PETROU, EXECUTIVE DIRECTOR, FEDERAL FINANCIAL ANALYTICS

Ms. PETROU. Thank you very much, Madam Chairman, and members of the subcommittee. I appreciate very much the opportunity to present the perspective of Federal Financial Analytics on the capital rule.

My firm advises financial services firms with an array of concerns on the Basel Accord. We also advise the Financial Guardian Group, which is an organization of those banks particularly con-

cerned with the operational risk-based capital sections in the accord.

I would like if I can to step back from the complexity of the accord because so much has been done and the hard work on this massive accord that Comptroller Hawke lately waved as evidence of its depth and breadth. Economists have been focusing very hard on how it will work and what its impact will be and how these models may or may not be appropriate. I think this is missing one fundamental lesson from decision theory, which is you should maximize, do the best you can, not optimize as it is put, letting in a sense the best drive out the good. This decade-long effort since Basel I was put in place in 1988, and was finally effective in 1992, we knew then that the rule had some significant flaws. Mr. Frank has pointed to one of those; the exemption from the capital framework of short-term lines of credit. That was a compromise that was known early on that that was in fact a very problematic one, because it created artificial incentives to structure loans and credit arrangements in a way to arbitrage the capital rules.

You have heard a lot from many institutions complaining and asking questions about the Basel Accord, but I do not think many have questioned the fact that Basel II would fix this error, even though fixing it will cost them a good deal of money. That is one of the things I would argue needs to be done quickly. I think other things that are on the table on which all of the regulators who were here before you in the first panel agree can be done, should be done. Waiting for this complex accord to grind its way to consensus and conclusion on the 1,000 pages it has already hit and growing may delay urgently needed action that would protect financial systems here and abroad.

It is essential, I think, that this action take place and take place quickly, because capital really does count. That message also gets lost in those 1,000 pages, but capital does count in the financial system in each of your districts. It is the fundamental driver of how profitability is measured. So a bank that has to hold more regulatory capital against a non-bank is less profitable in that business on the whole as another institution.

Economic capital is one of the ways the market says you look risky to me; you need to hold more capital; we want the shareholder putting up money before I as a debtholder or another counter-party bank take a risk. It is very important that regulatory and economic capital incentives align properly. In fact, that is the objective which Basel II was originally aimed at correcting; ending this regulatory arbitrage where regulatory capital and economic capital differs. To the degree that Basel II leaves these differences in place in areas like operational risk, for example, new forms of regulatory arbitrage will be created.

Similarly, to the degree that concern about rapid action to address areas where capital should drop; mortgages, small business loans for example, low-risk credit on which I think most people have agreed on about at least what the right initial risk-based capital rule ought to look like. You will create different incentives for different lenders to be in those businesses, to the degree that finally Basel II recognizes the appropriate economic capital for low-risk assets and drops it, the big banks using Basel II will get an

advantage over the smaller banks still left out of the system. That could drive credit availability in the regions, as well as the ability of local banks to structure products to meet local needs.

This regulatory arbitrage issue is also apparent in some of the smaller details of the capital rules. The issue of commercial real estate has been mentioned. I would like to bring up another area which is the treatment of small and medium-size enterprises, SMEs in Basel talk. I like small businesses a lot. I own one, but small businesses can be very risky. The Basel rules define small and medium-size enterprises as companies with annual revenues of $50 million; not the mom and pop shops we are used to thinking about as small businesses in this country.

The capital treatment for SMEs in the current version of Basel II is considerably lower than what most of analysts think is appropriate for economic risk. The reason is quite simple. Last year, Chancellor Schroeder threatened to take the Germans out of the Basel II negotiations unless the capital treatment for SMEs was fixed in accordance with German demands. That is a negotiating process. It is a legitimate one, but it is one where I think the Basel II rules remain potentially flawed. It is also an indication of the fact that this is a negotiation where the United States can, and when it is necessary to protect our interests, should intervene.

The operational area is one where I think that should take place. We have had a very full discussion of that, and I know David Spina will touch on that in his testimony. It is an area where quick action on supervisory improvements is urgently needed. Everybody agrees that we learned a lot very much the hard way after the tragedy of September 11. On Tuesday, the Basel Committee put out, rule two for operational risk management. That now needs to be implemented, and implemented in a meaningful way, not just in the United States, but in Europe and Japan.

We here have many tools to require appropriate supervision. I know Vice Chairman Ferguson cited some concerns that the U.S. regulators cannot enforce safety and soundness requirements. As a consultant in this field, I have never known them to be shy, nor should they be. Congress has given U.S. regulators many tools to enforce safety and soundness, and also to make the capital requirements count. One immediate step Basel II should look at is implementing comparable meaningful standards, including linking penalties to capital noncompliance. At the end of the day when the Basel II negotiations end, they will come back here. U.S. banks will be subject to unique sanctions if they fall below the sometimes arbitrary Pillar I thresholds. In the EU and Japan, nothing happens, we have seen that, and that is a central and immediate thing which Basel II needs to address.

The small bank issue is one I have mentioned briefly. There are some potential and significant issues there that need to be addressed and there can be rapid action on the agreed parts and sections of Basel II. Finally, the non-bank issue is an extremely important one, especially in the area of operational risk, where the banks that will be particularly adversely affected by operational risk-based capital, an arbitrary Pillar I charge, compete head-on with non-banks in the asset management and payments processing area.

Chairwoman BIGGERT. If you could wrap up, please.

Ms. PETROU. Excess capital is not that when it is put into the regulatory framework where these penalties would apply. It is very important that those capital determinations be made by the market.

Thank you.

[The prepared statement of Karen Shaw Petrou can be found on page 133 in the appendix.]

Chairwoman BIGGERT. Thank you very much.

Mr. Spina?

STATEMENT OF DAVID SPINA, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, STATE STREET CORPORATION

Mr. SPINA. Madam Chair, members of the subcommittee, thank you for this opportunity to testify today and, in absentia, I would like to thank Representative Frank for his introduction earlier. Let the record show that my mother could not have done a better job. It was very nice of him to be so gracious.

I am chairman and CEO of State Street Corporation, a global financial services company chartered as a bank in 1792 in Boston Massachusetts. We provide services such as custody and safekeeping for investment securities, fund accounting for investment portfolios, and investment management for public and private institutions such as pension plans, mutual funds, endowments and the like.

We believe the current Basel proposals will have significant negative competitive effects on U.S. banks, and if offered the option, we would choose not to opt into the new Basel operational risk capital framework. However, due to our significant position in our industry sector and the international nature of our business, we expect to be required by U.S. bank regulators to comply with Basel II.

Before I summarize our objections, I would make clear that we agree with the Basel Committee that operational risk is a critical risk issue. We view the U.S. bank supervisory system as among the best in the world, which is an asset to U.S. banks. The strength of U.S. regulation, however, also creates challenges as we compete with institutions subject to less intensive regulatory supervision abroad. The U.S. supervisory approach to operational risk today is already working. It is treated as a Pillar II matter under Baselspeak today, and we believe that this provides a strong foundation for even better risk management practices going forward.

The Basel Committee proposal would impose a new capital framework or requirements on banks based on statistical measures of operational risk. Using the Basel terminology, operational risk would fall under Pillar I, which establishes capital standards, as opposed to Pillar II, which addresses risks through supervision. The Basel definition of operational risk is a very, very broad definition, including nearly all risks inherent to conducting a business.

Let me explain State Street's experience with operational risk. In the over 200-plus years that we have been in business, we have learned that relying on a capital cushion to absorb losses is a crutch, not a solution. Our focus is on rigorous risk management with a goal of reducing errors and avoiding losses. We minimize

operational losses by making ongoing investments in systems, people and business continuity planning, and by ensuring our contractual arrangements clearly allocate risk between State Street and our clients. Our long-documented history of very low operational losses tells us that this approach works.

Operational risk, of course, is part of doing business for any company, but it is really an issue of earnings at risk, rather than capital at risk. In the very few highly publicized bank failures often attributed to catastrophic operational losses, no reasonable level of capital would have prevented bank failure. Adding a new regulatory capital requirement for operational risk will have a detrimental effect by creating disincentives for effective risk management and by creating an uneven competitive playing field for U.S. banks.

Let me make four points very quickly. The Basel Committee's proposal creates a perverse incentive for banks to disproportionately focus financial and management resources towards meeting capital requirements, rather than on making essential investments in systems, people and business continuity planning. This is a little bit of the paying twice issue that Representative Maloney was referring to earlier.

Second, the Basel Committee's proposal would disadvantage banks competing with non-banks. In the U.S., non-bank investment managers, fund accountants, payments processors and broker dealers are not subject to the current bank capital rules, nor will they be subject to the new capital requirements for operational risk. These non-banks include financial services firms that are well known; Firms like Fidelity Investments, our neighbor in Boston, SunGard, Merrill Lynch, and numerous others whose names you would recognize. The result under the Basel proposal is an unfair competitive disadvantage for banks competing with these non-bank financial firms.

Third, the Basel Committee's operational risk proposal will hurt U.S. banks in the international marketplace. The proposal's untested quantification methods create a high probability of inaccurate capital assessments. Such errors disadvantage U.S. banks, which face far quicker regulatory response when we step over a regulatory line than we believe our competitors face in other countries. For example, U.S. banks are subject to the prompt corrective action required under FDICIA. It is prompt and it simply does not exist elsewhere in the world. In short, Basel creates a high risk of uneven application and enforcement, I think to the detriment of U.S. banks.

Finally, the banks that are most negatively impacted by the Basel Committee's proposed treatment of operational risk are what people often call trust banks; banks that specialize primarily in holding individuals' and institutions' assets as a custodian, fiduciary or investment manager. Disproportionately penalizing such banks with a new capital requirement could discourage competition and participation in such business lines, to the ultimate detriment of all investors.

In summing up, I urge the subcommittee and the U.S. regulators to consider the potential detrimental effects of the operational risk proposal on U.S. banks, and instead to insist on the adoption of a

rigorous supervisory approach under Pillar II of the proposed Basel framework.

Let me just simply say thank you and stop there. I look forward to your questions.

[The prepared statement of David Spina can be found on page 160 in the appendix.]

Chairwoman BIGGERT. Thank you very much, Mr. Spina.

Mr. Ervin?

STATEMENT OF D. WILSON ERVIN, MANAGING DIRECTOR AND HEAD OF STRATEGIC RISK MANAGEMENT, CREDIT SUISSE FIRST BOSTON

Mr. ERVIN. Thank you. Good afternoon, it is an honor to be here. My name is Wilson Ervin. I am presenting testimony today on behalf of Credit Suisse First Boston, and on behalf of our trade group, the Financial Services Roundtable.

CSFB is a major participant in global capital markets, employing approximately 22,000 people. We are headquartered in New York and regulated as a U.S. broker dealer and a U.S. financial holding company. CSFB is also regulated as a Swiss bank and will be required to use Basel II. Our implementation will be governed primarily by the Swiss EBK, but also by other regulators including the Federal Reserve and the UK FSA.

As head of CSFB's risk management functions, my job is to assess the risks of our bank and protect our capital. That is a goal similar to many of the goals of bank supervisors. We agree with the importance of bringing the current regime up to date and fully support the objectives of Basel II. I personally developed tremendous respect for the regulators who have worked on Basel II, many of whom have been in the room today. They have addressed a great many challenging issues with stamina and sophistication, and they have been tenacious in trying to get to a best practice solution in each one.

Yet while there is much to admire in the new rules, there are also many elements that raise serious concerns. We hope this committee, in conjunction with regulators and banks, will use this opportunity to improve the current proposal so that Basel II can live up to its original and very worthy goals.

Today, I would like to focus on four macro issues that Chairman Oxley mentioned earlier. They are, number one, cost, complexity and adaptability over time; number two, pro-cyclicality or the risks that the new accord could actually deepen economic recessions; number three, operational risk; and number four, disclosure requirements.

The first topic I would like to address is the high cost and complexity of the new rules and the effect this will have on whether the rules remain relevant over time. Most of this complexity can be found in Pillar I, which describes the recipe for calculating capital requirements. This is more than 400 pages, as you saw earlier today, and more than 12 times the length of the original Basel Accord. It is a normal result from this kind of process. Once you start trying to boil down the complexity of the real world into a series of mathematical formulas, it is very hard to stop halfway. I am concerned that this very complexity will make the rules difficult to up-

date over time, and potentially lock us into that "early-2000" mindset regardless of what the future looks like.

An example of this complexity is the proposal for securitization, which is a common method for financing housing and credit cards. The draft proposal in this area alone runs to 40 pages and contains daunting formulas, as you can see from the examples submitted in annex one of my written testimony.

The cost of implementation will be high. We estimate that approximately $70 million to $100 million in startup costs for our firm will be spent, even though we already use fairly sophisticated techniques for measuring economic capital on an internal basis. When these costs are multiplied by the thousands of banks within the global banking system, this will amount to billions of dollars in additional costs. Some of these costs will be passed on to consumers and corporations, and some of these costs may force banks to exit certain activities and leave those markets to unregulated entities.

Procyclicality: the new rules will change how banks calculate their capital and the amount of business they choose to do. We have analyzed the impact of applying the Basel II rules to loan portfolios over the last 20 years of credit cycles. Our calculations indicate the new rules require much more bank capital during economic recessions when compared to the current system. As an example, let's think about the last few years. This period has seen a large number of corporate downgrades in a sluggish economy. Unlike the current accord, the proposed system will require significantly more capital in that environment. Under those circumstances, banks will have to choose between raising more capital or cutting the amount of lending they do.

My personal estimate is that our bank would have cut back our lending by perhaps 20 percent if the Basel II rules were in place last year. If all banks cut back on lending at the same time, as they will tend to do under a common global regulatory regime, the potential adverse impact on the real economy could act to lengthen and deepen economic recession. While it is difficult to estimate the size of this effect, I would submit that herd behavior can make small problems into big ones.

In addition to credit risk reforms, Basel II also focuses on operational risk; the risk of breakdown in systems and people. While a more refined scientific approach to credit risk has considerable merit, the proposed quantification of operational risk is highly problematic, in my view. It would be great to quantify and control all risks with statistical methods, but there are fundamental reasons why this would be difficult to do with operational risk in practice. You have mentioned legal risks several times, and I think that is a particularly tough nut to crack.

Can you really calculate the maximum loss a bank would suffer from that, or from potential fraud, an IT breakdown or a major disaster? How do you estimate how likely those events are? I have yet to see anything substantial that suggests that operational risk really is measurable in a way that is similar to market and credit risk. In fact, I think we may be creating a real danger, a false sense of security that we have measured operational risks and therefore controlled them.

One of the strengths of the proposals is they go beyond capital calculations and also look to improve market transparency. While we support the concept behind the proposed rules here in Pillar 2I, the detailed proposals are cause for concern. We currently publish about 20 pages of detailed disclosure about risk in our annual report. We estimate that Pillar 2I would add another 20 to 30 pages of much more technical data to that total, but provide little of value to the reader. Indeed, few people in my experience are able to digest all of the information already presented on risk, and now this information would bury them in a deeper, more technical pile of data. While we support transparency, we believe the current proposals are more likely to confuse than to illuminate.

In sum, we believe the Basel effort is a worthy goal, and we have a high regard for the efforts of the regulators who have worked very hard to build it. CSFB and the Financial Roundtable have also worked hard to contribute to that discussion in a constructive and open manner. Simplifying the complex rules currently found in Pillar I will require strong discipline in the next round of drafting, and return to some of the original philosophy of the project. I believe that much can be accomplished if we increase the emphasis on principles, rather than formulae in Pillar I, and if we increase the weight of Pillar II.

Pillars II and III have real people on the other side—regulators and the market. Real people can adapt to changes and new markets much more easily than a rule book can. This puts the burden back where it belongs, on the shoulders of bank management to demonstrate to the regulators, to you and to the public that we are doing a good job. That is in the spirit of the Sarbanes-Oxley reforms, and I think it is a smart and durable way to improve discipline.

Thank you very much.

[The prepared statement of D. Wilson Ervin can be found on page 58 in the appendix.]

Chairwoman BIGGERT. Thank you very much, Mr. Ervin.

Ms. Moore?

SARAH MOORE, CHIEF OPERATING OFFICER, THE COLONIAL BANK GROUP, INC.

Ms. MOORE. It is a pleasure, Madam Chair, to appear before the subcommittee to present our concerns on the revised Basel capital accord. I am Sarah Moore, executive vice president and chief operations officer of Colonial Banc Group, which owns Colonial Bank, a $16 billion bank operating in the southeast, Texas and Nevada.

We anticipate the impact of the new accord will be far-reaching, as it will affect not just the largest banks, but rather its effects will be felt by banks of all sizes. Moreover, it will have a measurable effect on the nation's economy. The revised Basel capital accord is an extremely complex document. We believe Basel II has the unintended consequence of giving the largest U.S. banks an unwarranted competitive advantage over smaller institutions that compete against them, and importantly, places all U.S. banks at a competitive disadvantage to non-banks and to foreign banks.

We share the concerns about operations risk, but the most problematic issue in the accord for Colonial Bank and other regional

banks is the proposed treatment of commercial real estate. We further believe that as drafted Basel II will lead to a loss of credit opportunities in the real estate sector since the accord treats lending to this area in an unreasonably disparate manner. Proponents of this new accord have argued that the accord will reduce the capital requirements for certain banks. However, with respect to real estate lending, no bank is able to utilize the tools under the accord for this purpose.

While all other types of lending can utilize tools envisioned in the accord, real estate lending is set on a different shelf. Commercial real estate lending is identified in the accord as a more volatile high-risk type of lending than every other type of lending. banks that use risk assessment tools to measure performance of their real estate portfolios cannot, regardless of the performance of those portfolios, gain entitlement to lower capital standards, as the accord allows them to do with respect to every other type of lending.

As a result of this arbitrary characterization of real estate lending and despite the hundreds of millions of dollars that will be spent in developing models and tools needed to comply with the accord, banks will be unable to adjust their capital levels to reflect the actual risk levels posed by real estate lending as determined by the tools themselves.

Why did the Basel Committee use net charge-offs for all U.S. banks to develop risk-based capital allocations? I'll tell you. The numbers do not support the capital treatment provided under the new accord. This is made quite clear in the graph which we have attached to my written testimony. This graph illustrates net charge-offs by loan type for all commercial banks from 1985 through the third quarter of 2002. You can see from the data, since 1995, right in this area, that commercial real estate loans have had lower net charge-offs than consumer loans and C&I loans. Yet under the accord, banks must carry higher levels of capital for commercial real estate loans than all other types of loans.

Let's walk through an example of how a commercial real estate loan is treated in the proposed accord, versus an unsecured loan to WorldCom. Assuming we have a $100,000 loan collateralized by a fully-leased office building, the borrower has performed as agreed, with a good repayment history, this loan would carry a capital charge of $8,000. By contrast, a $100,000 unsecured loan to WorldCom, which had a Moody's credit rating of A2 prior to WorldCom's announcement of accounting irregularities, would have carried a capital charge of only $1,600. Which one do you perceive as higher risk: a loan collateralized by real estate, which you can touch and re-sell, or a promise to pay from a telecommunications company? While the accord is intended to strengthen banks, in this instance it encourages making unsecured loans, rather than secured ones.

The proposed accord also would create an uneven playing field as a result of the lending patterns of the largest banks in the country compared to regional and community banks. The level of commercial real estate loans, as a percent of total loans, is twice as high for banks under $15 billion as it is for banks over $200 billion. In the southeast, non-mammoth banks carry an even greater load.

Thus, an automatic and harsh treatment of commercial real estate disadvantages smaller institutions far more than larger ones.

The inherent flaws in the accord would benefit only a handful of the largest U.S. banks, while the majority of community and regional banks would be burdened by higher capital requirements and increased expenses. Moreover, the disparate treatment of commercial real estate lending will manifest itself through significant credit crunches and dismal economic performance.

With that in mind, we urge the Congress to require that prior to any action on an international agreement on capital standards, the federal banking agencies, in consultation with the Secretary of Treasury, evaluate the impact of such a proposed agreement, take into account a number of factors such as the impact of the proposal on small and medium-size financial institutions, the real estate markets, and other factors, and then submit a report to Congress.

I thank the subcommittee for allowing me to be heard today.

[The prepared statement of Sarah Moore can be found on page 120 in the appendix.]

Chairwoman BIGGERT. Thank you very much. I appreciate your testimony. Once again, we will have a round of questions at five minutes each, so please keep your questions short and your answers, and we will have more times for questions.

I will recognize myself for five minutes. Ms. Petrou, which countries win and which countries lose as a result of Basel II? Are France and Germany and the United Kingdom going to be treated equally with the United States under the proposed new accord? You mentioned in your testimony that Germany threatened to leave the negotiations if they did not obtain favorable treatment for small and medium-size enterprises? How common are these tactics?

Ms. PETROU. This is a negotiation. The rules will apply equally to all parties in the Basel accord; the United States, UK, Germany, France, Japan and so forth. The real question is once each home country's regulator opens the rulebook, how will they interpret it and how will they enforce it.

Chairwoman BIGGERT. Thank you. Mr. Ervin, your bank seems to be in a unique position of having regulation by both the United States and Switzerland?

Mr. ERVIN. As well as the UK and I believe approximately 100 other regulators around the world.

Chairwoman BIGGERT. So you have many host countries to be under regulation. Do you think that there is going to be; how will that work?

Mr. ERVIN. We are concerned. We have not seen how it will work yet. We already have tension, where occasionally one regulator will advise us to do one thing, and another regulator will request something different, and we need to comply with both. Sometimes that is very difficult in practice. That is a catch-22 situation. To date, that has been reasonably easy for us to manage, working cooperatively with regulators in the UK, Switzerland and here, which are our primary regulators. But the Basel accord is much more complex. It goes much deeper. I think you are going to have much more serious home-and-host problems going forward. The costs that we have talked about here will multiply very dramatically if we have

to maintain multiple systems to satisfy the needs of multiple regulators.

Chairwoman BIGGERT. Do you see that with this new complex structure as potentially having an adverse impact then on global trade in financial services? Will this drive further divisions in an already sensitive area?

Mr. ERVIN. I think you will see some significant changes in trade in financial services. I think this accord is enough of a "big bang" so that we do not know all of them yet. I am not smart enough to predict exactly which changes will happen. I do think there will be some incentives that potentially increase consolidation in some areas, some places where it will affect banks differently in different countries, and also some areas where institutions have to become non-banks to compete effectively. I think you will see a lot of changes in trade, I am just not sure what they will be exactly.

Chairwoman BIGGERT. Thank you. Ms. Moore, what interaction has Colonial Banc Group had with the Federal Reserve and the other regulators during the negotiations surrounding Basel II? Has your input been solicited by the Fed?

Ms. MOORE. It depends on which Fed you are talking with. The Federal Reserve Bank in Atlanta has solicited our comments, they met with us, they told us to get ready to begin to comply with the accord, which is contrary to what Vice Chairman Ferguson testified to this morning, that it will apply to only the 10 largest banks, and yet the Federal Reserve has told us that we need to get ready; that the expectation is that we should comply with the accord. We have had really no input into the process. I don't believe our voices were heard, it stopped at the Atlanta Fed.

Chairwoman BIGGERT. I thought that as a regional bank that you would perhaps decide to be in it, or decide not to, but this sounds like it is more you might be told that you are in it.

Ms. MOORE. The Federal Reserve told us that they expect us to begin compliance with the accord. We also believe that the market forces will dictate that we comply. We are a publicly traded company. We have 124 million shares of stock outstanding. We feel like the market will force us to compliance, or we will be viewed as unsophisticated. Of course, we are very concerned because of the competitive disadvantages that we believe this will create on a regional bank our size.

Chairwoman BIGGERT. If this were so, or even if you did decide, if that was changed, could you be prepared by January 1, 2007?

Ms. MOORE. No.

Chairwoman BIGGERT. Have any resources been directed to the effort?

Ms. MOORE. A whole industry has developed around providing banks resources to help them comply with Basel. We have consultants calling us each and every day; we can help you; we can help you; buy this software; we will help. We do not have the internal resources. We are busy trying to run a $16 billion bank every day. I am the chief operations officer. We have a lot of technology projects that are trying to keep us competitive. This will divert resources away from things that will make us more profitable and make us a stronger financial institution, no doubt about it.

Chairwoman BIGGERT. Do you have any idea what this could cost your institution to implement Basel II?

Ms. MOORE. It will be tens of millions of dollars, not counting the internal man hours associated with Basel II.

Chairwoman BIGGERT. Thank you very much.

The gentlewoman from New York?

Mrs. MALONEY OF NEW YORK. I defer to the ranking member.

Mr. FRANK. I thank the gentlewoman, because I am going to have to leave after this.

I would ask particularly the two bank representatives, Mr. Ervin and Mr. Spina, I remember asking Mr. Ferguson why publicity was enough, because he acknowledged that transparency would be the same in either case. His answer to me was, better they should go with Pillar I with their ability to impose a capital requirement, than to engage in Pillar II because in that case they may have to say rude things about you, and that would undermine the cooperative relationship. My question then is, from your standpoint, would you think it would be better to have Pillar I, which would have this I think somewhat rigid requirement, would you trade that for Pillar II with the possibility that that might lead them occasionally to make public comments about you? It seemed to me that he had it reversed in what I would want if I were involved, and I wondered if you would both address. Mr. Spina, why don't we start with you?

Mr. SPINA. I think that in one sense we would all want simple rules, but what we are dealing here in capital allocation and capital adequacy for a bank is complex. If you imagine a dialogue with a regulator and the Federal Reserve is our principal regulator at the bank level, because we are a state-chartered bank—if they have a Pillar I rule, then they start with the high ground, the authoritarian position. They have the weight of everything behind them, so we do not have any wiggle room. I am not saying that we should, in some cases.

Pillar II, does allow for more dialogue Back and forth, but at the end of the day it is still the Federal Reserve, that is the decisionmaker and they can still pull the rug on us and issue a cease and desist order or something like that. The question is whether they start the dialogue with all the authority behind them, or whether they finish it. I would much rather have it under Pillar II.

Mr. FRANK. Mr. Ervin?

Mr. ERVIN. I would agree with that. Like State Street, we pay attention when the Fed talks. That is regardless of whether it is Pillar I or Pillar II. Either one would be public. If your Pillar I calculations fall below a level, that is as public as if you were in a "name-and-shame" situation under Pillar II. Our point has mostly been that the mathematics and the modeling capability fits in Pillar I, and to my mind operational risk modeling really does not seem to be built on solid foundations.

Mr. FRANK. I appreciate that. It did seem to me, as Mr. Ferguson explained, he said basically they wanted to stick with Pillar I rather than Pillar II because if they did it under Pillar II, they might reach the point where it almost sounded like it was Pillar I, so they start out with Pillar I. That is, they got to that point and I was not persuaded by that.

Let me also ask, again this is new to us, but in some ways it seems to me the capital charge may be almost irrelevant to the evils they say they are trying to ward off; we have got ING, baring and some of the other, the Allied Irish Bank; would the level of capital charge we are talking about have been of any use, Ms. Petrou, in the situation of those, if there had been a capital charge, would that have helped greatly?

Mr. SPINA. I do not believe that it would have been sufficient to cover the losses in those cases.

Mr. FRANK. Ms. Petrou?

Ms. PETROU. No, I would certainly concur with that. I noted in Chairman Powell's testimony he talked about operational risk as the cause of many recent bank failures, and then he points out correctly that those operational risks were internal fraud, for example in Keystone. This committee had many hearings on the failure of Keystone National Bank, and you will recall that that internal fraud was in part inside chief executive officers burying piles of paper on assets they had said they had sold, they did not sell them, and they buried all the paper in their own backyard.

I do not know what an operational risk-based capital charge would have done. To expect that on the one hand the risk managers would be calculating some form of measurement charge with the possibility upstairs, and then—

Mr. FRANK. I appreciate that, but again there is obviously the analogy here to the capital that you need for lending risk, but it does seem to me with lending risk you are much more in a more or less situation that you may miscalculate. Whereas with this kind of risk, it seems to me more likely to be an either-or than a more-or-less, and it does seem to me that the capital charge and the level of a capital charge is more suited to the former. Is that a reasonable view, Mr. Ervin?

Mr. ERVIN. I think that is a very reasonable view. It goes to the fundamental difference between the two. In market and credit risk, you take those risks specifically for the prospect of gain. It is part of your business. It's different with operational risk, nobody wants more fraud risk or more legal risk. You try and stamp that out as soon as you can find it. So that makes it a fundamentally different animal. I think that is one of the core reasons why it is hard to put under Pillar I.

Mr. FRANK. Yes, it does seem to me that more-or-less and either-or are different conceptual frameworks, and that we ought to do that. I assume we would agree that there ought to be very serious supervision here about management risk.

Chairwoman BIGGERT. The gentleman's time has expired. The gentlewoman from New York?

Mrs. MALONEY OF NEW YORK. Clearly, I think we need more hearings on this, and I am glad that the ranking member had called for this initial hearing, and I hope that he calls for more, because I think some very serious issues have been raised when three executives from American business and international business point out the flaws in this and the ways that they perceive it will really hurt their ability to provide services to our constituents, to consumers.

I would really like Ms. Petrou to respond to the rather startling example that Ms. Moore gave, where the credit risk of buying WorldCom under the Basel accord, according to her example, would have been perceived a higher capital standard for the real estate than for WorldCom. Isn't the whole point of Basel to make the capital risk relationship more true to reality? The example she gave was exactly the reverse. So I would like to hear your comment on it.

I feel that one of our roles in government is oversight. I am very concerned about any competitive disadvantage. If the bankers could just in your closing remarks go over what you think. We certainly do not in this country want to do anything that makes it harder for the American business, American financial banks to operate, because then that has a negative impact on people, on our consumers, on our constituents. I would like you to comment on the real life, real world consequences that this will have on your profitability, your products, and the impact on your constituents. But Ms. Petrou, could you please comment on the; I found her example startling—could you comment on that please?

Ms. PETROU. Yes, ma'am. It is. It is an example of the many problems I think that are buried in those thousand pages. When people sit down and start to run them, there are startling results. This is in part because the treatment of credit risk mitigation is still very incomplete. I would argue it is one of the things that Basel ought to be doing quickly; collateral, certain forms of loan insurance. There are numerous ways we have learned over the years to put somebody in the middle between a lender and loss. There is a lot that could be done to fix that, but I am not convinced the current version does.

Mrs. MALONEY OF NEW YORK. I want to thank Mr. Oxley for calling for these hearings, and of course my colleague, Ms. Biggert, with whom we work on so many issues. Could you comment on the competitive disadvantage that all of you have testified, and also whether or not the Fed or the OCC has responded to your concerns when you have raised them.

Mr. SPINA. From State Street's perspective, we compete in much of our products and services with non-banks. Accounting firms and data processing firms can offer similar services. We do offer bank-related services, which is why we keep our bank charter as well. But clearly, if we had a capital charge, that would impose a cost on the company. We would have to earn a return on that capital and our competitors would not be burdened with that cost. So I think it would be a material event in the sense that it would force us to reexamine our business model entirely and see how we provide those services.

In terms of dialogue, we are uniquely focused in this kind of business, and we have benefited from a lot of dialogue and access to the Federal Reserve. I give them very high marks on that. The Boston Federal Reserve, the New York Federal Reserve and the Board of Governors have sponsored meetings both at State Street and in Washington and in New York. We have made our points, but we do not seem to come to closure, which is really why we are here. They hold their position that they think operational risk needs to be Pillar I, notwithstanding the arguments.

I have seen them bend in other related situations on different aspects of the credit risk proposal, after dialogue, and the proposals have gotten better, and this whole advanced management approach is a lot better than where we started a couple of years ago. However, we still cannot get them all the way to Pillar II, which is where we are focused.

Chairwoman BIGGERT. I hate to break in here, but we have just a few minutes because of the timing of the room. So Mr. Ervin, if you could just in a couple of sentences, and Ms. Moore, we will have to complete our hearing.

Mr. ERVIN. I would support Mr. Spina's comments. I think that some of the biggest differentials are going to be between banks and non-banks. We compete very heavily with non-banks in many of our lines of business. I am worried that we will become less competitive and potentially will have to cede some of those lines of business to non-banks going forward.

With respect to national implementation, as I said before, we see a lot of differences in different countries. I would tell you that you do not need to worry about Switzerland. They are one of the toughest regulators out there. They are very proud of their banking tradition, and are very strict. But I think there is a risk that the stricter regimes, such as Switzerland or the U.S. regime or the UK regime, could be disadvantaged versus other countries.

Ms. MOORE. I like the idea of more hearings. It is an excellent idea. I feel like the industry, especially banks of our size, are just now getting up to speed on the impact of Basel. When the regulators are telling you, and making public statements, that only Basel will apply to the top 10 banks; banks are thinking, great, I don't have to worry about that 600-page complex document, when in reality they should be worried about it. I believe these hearings will raise the awareness of the banking industry and get more people like Colonial Bank involved in the process. Thank you.

Chairwoman BIGGERT. Thank you. The chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Thank you all very much. You have been an excellent panel, and thank you for sitting and waiting through the other panel. We really appreciate it. I wish we had more time, but maybe you will be back. Thank you very much.

The hearing is adjourned.

[Whereupon, at 12:57 p.m., the subcommittee was adjourned.]

A P P E N D I X

February 27, 2003

Opening Statement
Chairman Michael G. Oxley
Committee on Financial Services
February 27, 2003
"The New Basel Accord — Sound Regulation or Crushing Complexity?"

I would like to welcome the witnesses this morning for what I anticipate to be a spirited hearing on the revisions to the Basel Capital Accord currently under discussion at the Bank of International Settlements. We have two very distinguished panels before the Subcommittee today, and I look forward to their testimony.

I want to commend the Federal Reserve, the OCC, the FDIC and New York Fed Chairman McDonough in particular for spearheading the reforms of the Basel Accord. The authors of Basel II have been working diligently for nearly five years to develop a workable regulatory capital regime. The primary goal of Basel II is to provide flexibility and risk sensitivity in the capital adequacy framework. This goal is laudable and will be a vast improvement over the one size fits all approach of the Basel I Accord and will reduce risk arbitrage under the current system.

This is a topic of critical importance to the banking sector and the economy. If we must sacrifice speed to achieve a workable and appropriate solution the first time, I see no problem in doing so.

Basel II will impact not only the largest U.S. financial institutions, but financial institutions of every size and structure. The way banks calculate risk and compete with one another will be dramatically changed under Basel II. Specifically, I am concerned that as it is currently written Basel II will force medium sized institutions to either consolidate to compete with the largest banks, or simply cease to offer business lines that the largest banks offer. According to the Federal Reserve, Basel II will only be mandatory for the 10 largest banks in the U.S. and will be voluntary for the next 10 largest banks. My concern is what happens to the next 10 institutions and the 10 after those.

I believe that the proposed operational risk charge could also result in unintended consequences forcing banks to quantify the risk of such intangibles as litigation risk, employee fraud and system failure. Operational risk assessment seems to be much more art than science and could force institutions to take large capital charges when there is little need for them. Such charges may disadvantage domestic financial institutions by requiring capital charges for factors that are difficult to quantify and are significantly less likely to occur in other countries.

Basel II is extremely sophisticated. The cost and complexity of the proposed Basel II accord could prove to be overly burdensome for both the institutions and the regulators charged with enforcing the new provisions. This proposal will completely change the way that banks are overseen, as such the regulators are going to have to retrain and hire new staff and develop new methods for bank supervision. We need to ensure that all parties affected by these changes are prepared to ensure the smooth implementation of Basel II.

In conclusion I want to reiterate my support for reform of Basel I, there is no question that change is needed. However, I strongly urge the Federal Reserve and the other regulators to give serious consideration to all the comments they hear today and the comments that will be made to the third consultative paper before moving forward with any rule making. I am troubled that a fast-track timeline for the completion of the Basel II Accord has already been established. I understand that the authors of Basel II are seeking final rule making to be completed by the end of this year. For a regulatory structure so complex and so far reaching, we must take a go-slow approach in order to ensure that all voices have been heard, and that we mitigate or eliminate any unintended consequences of Basel II to the banking sector and the U.S. economy.

RAHM EMANUEL
5TH DISTRICT, ILLINOIS

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Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
February 27, 2003

I would like to thank Chairman King and Ranking Member Maloney for holding this important hearing on the proposed revisions to the Basel Capital Accord. I also appreciate that our distinguished guests from the regulatory agencies, as well as the industry witnesses, have taken the time to share their views with us on this important topic.

The original Basel Capital Accord was developed for two reasons: 1) to promote the international convergence of banking capital regulation so that major international banks would compete under similar capital rules; and 2) to promote a safe and sound banking system on a global basis.

While the various countries' supervisors have implemented and enforced the original Basel Accord in slightly different ways, there is no doubt that a greater level of consistency in international capital regulation has resulted from the Accord's implementation.

However, given the changes to financial markets that have occurred in the decade and a half since the original Basel Accord was adopted, it is appropriate that international bank regulators have reconvened to consider revising the Accord, and to recommend whether or not improvements can be made to promote greater safety, soundness and economic efficiency. Therefore, I commend the U.S. and international regulators for their hard work in considering changes to strengthen international capital regulations.

With that in mind, the witnesses addressed several important issues this morning.

I was very interested in the views expressed by the regulatory and the industry witnesses on the implications of the proposed 20% operational risk capital charge. As with many of the proposed changes to the original Accord, it is important that onorous requirements do not put U.S. banks at a competitive disadvantage in the international marketplace.

Second, the witnesses discussed the 'internal models' approach that several of the major international banks are expected to adopt. However, I would like to

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hear additional details about how the U.S. bank regulators intend to oversee banks that elect to use this approach and the implications it will have for these institutions.

Third, the witnesses addressed the effect that the proposed changes to the Accord will have on our national economy. It has been alleged that the current Accord has caused economic distortions since in many cases, the amount of capital that banks are required to hold does not always match the true economic risk associated with certain assets. However, it also has been suggested that a more flexible system that results in banks holding more capital in bad times and less capital in good times may adversely effect the economy by decreasing credit availability when it is needed most and making money too available during good times. These issues should be addressed in greater detail before the new Accord is finalized

Once again, I extend my thanks to our witnesses for appearing before this Subcommittee. I look forward to working with my colleagues as we continue to evaluate the proposed changes to the Accord.

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The New Basel Accord

TESTIMONY OF D. WILSON ERVIN

on behalf of

Credit Suisse First Boston

and

The Financial Services Roundtable

Hearings on Basel Capital Reforms
House Committee on Financial Services
February 27, 2003

Testimony of D. Wilson Ervin
Hearings on Basel Capital Reforms
House Committee on Financial Services
February 27, 2003

Introduction

Good morning Mr. Chairman. I want to thank you for holding these hearings today and allowing me to appear before the Committee. My name is Wilson Ervin and I am a Managing Director of Credit Suisse First Boston ("CSFB")[1]. I head our Strategic Risk Management (or "SRM") department and also chair its risk committee. I am presenting testimony today on behalf of CSFB and on behalf of our trade group, the Financial Services Roundtable[2]. CSFB employs approximately 22,000 people, primarily in the United States, and is a major participant in the capital markets. It ranks among the top firms in raising money for high yield companies and is a leading underwriter of mortgage and credit card financing. Moreover, the firm is among the largest managers of funds invested in private companies.

My Department at CSFB – SRM -- is responsible for assessing the risk profile of CSFB on a global basis and for recommending corrective action where appropriate. This objective is similar to many of the goals of bank supervisors, including the drafters of the proposed Basel Accord - to deter large losses and protect bank solvency.

The Basel II Capital proposals have been the topic of intense discussion and debate in the financial and regulatory community for the past several years. The proposed Accord is not a minor refinement to the bank regulatory process, but is, instead, a wholesale reform of bank regulation -- a regime that covers roughly $2 trillion of capital and is a key economic engine for most developed markets. While the revisions are well intended and many of the specific

[1] Credit Suisse First Boston (CSFB) is a leading global investment bank serving institutional, corporate, government and high net worth clients. CSFB's businesses include securities underwriting, sales and trading, investment banking, private equity, financial advisory services, investment research, venture capital and asset management. CSFB operates in more than 89 locations across more than 37 countries on six continents. The Firm is a business unit of Zurich-based Credit Suisse Group, a leading global financial services company.

proposals are well-drafted, a change of this scale invokes the "law of unintended consequences". The impacts of these seemingly technical discussions will be far reaching, and we would be wise to consider them carefully before implementation.

Before I start, I would like to note that I have personally developed tremendous respect for the diligence and stamina of the regulators who have worked on Basel II. They have had to address a great many complex and challenging issues, and they have been tenacious in trying to develop a "best practice" solution for each. Balancing all of this and applying it to very different financial markets around the world - with political sensitivities in each -- does not make this an easy job.

Yet, while there is much to admire in the new rules, there are also many elements that raise serious concern. Basel II has considerable momentum, and most people in the industry believe it will likely be implemented in the relatively near future. CSFB has worked hard to be a "constructive critic" of the new rules, particularly in respect to practical implementation. However, in spite of the hard work of the Committee and industry, substantial flaws still remain. In my opinion, these flaws are currently large enough to outweigh some of the very useful reforms that are included. We hope the Committee - in conjunction with regulators and banks - will use this opportunity to repair the process so that the Basle II reforms can live up to their original, very worthy goals.

Today I would like to focus on four "macro" issues that arise out of the proposed Accord:

1. The current Basel proposal is too complex, too costly and too inflexible to provide a robust, durable framework for bank supervision going forward. Implementing the proposed accord may have the effect of freezing the development of good risk management, and locking it into an "early 2000's" mindset.

2. The new Accord and its sensitivity to credit ratings will reduce liquidity in the credit markets during economic downturns, potentially extending or deepening economic recessions ("pro-cyclicality").

[2] The Financial Services Roundtable is a national association representing 100 of the largest integrated financial services companies in the U.S. providing banking, insurance, securities, and investment products and services to American consumers.

3. The Operational Risk charge proposed by the Basel Committee is premised on a fundamentally flawed concept – it is built on sand, not a solid foundation – and could actually distract from good risk management.

4. The disclosures required under the new Accord are likely to add at least 20 pages of highly technical disclosure to bank annual reports, raising costs and providing little or no information of value to the reader.

CSFB will be required as a Swiss bank to implement Basel II. Our implementation will be governed primarily by the Swiss EBK, but also by other regulators, including the Federal Reserve and the UK FSA. This interlocking patchwork of regulation can pose significant challenges for an international bank such as ourselves -- for example we have been required to implement conflicting risk calculations by different regulators, making compliance a difficult "Catch-22". While we have been able to resolve these issues to date, this potential tension between "home and host" regulators will become a bigger issue given the much wider and more detailed Basel II regime.

Complexity, Cost, and Adaptability

The first topic I would like to address is the overall cost & complexity of the new rules, and the effect they will have on whether the rules remain relevant over time. CSFB believes that the framework currently under consideration by the regulators is simply too complex and too prescriptive to be an effective supervisory tool. The new rules will shift the regulatory regime strongly toward an inflexible, formula–based system, and will diminish the important role that is currently played by human judgment.

Most of this complexity is to be found in Pillar I, which describes the "recipe" for calculating capital requirements. The last draft of the Pillar I calculations ran to approximately 400 pages, more than 12 times the length of the original Basel Accord. The final page count is likely to run well over a thousand once all the technical papers are included. This is a common result from this kind of process. Once you start developing a system that attempts to capture the complexity of the real world into a series of mathematical rules, it is very hard to stop halfway. One issue or another will always be of major concern for some institution or country. Consequently you end up with a very elaborate system that tries to address all circumstances by becoming ever more complex, but which may begin to stagger under its own weight.

A particularly germane example of Basel's complexity is its proposal for asset securitizations. Asset securitizations are one of the most basic forms of financial transactions in today's marketplace, and are a keystone of how the US markets currently finance residential mortgages, consumer credit card balances and automobile loans. The draft rules being proposed by the Basel Committee for asset securitizations alone run to 40 pages – more than the entire 1988 Accord. They are daunting and often difficult to interpret (see Appendix 1) . The result is that only a few experts in each area are likely to understand this and other specialized rules of the Accord.

The monetary cost of complying with these rules for banks will be significant. For Credit Suisse Group, our holding company, we estimate that our initial costs will be $70mm to $100mm just to implement the system, plus substantial ongoing costs. Multiply that by the thousands of

banks within the banking system and this will amount to many billions of dollars of additional costs. Some of these costs will be passed on to consumers and corporations, and some of these costs may force banks to exit certain activities leaving these markets to unregulated entities.

A major driver of the cost / benefit ratio of the new rules will depend on how they are applied. For example, there are more than 80 specific requirements that must each be met to use the so-called IRB advanced credit system. If each of them is interpreted and tested to rigorous audit standards, there will be enormous costs in compliance, though the relevance to actual risk management will be small. I would note to the Committee that implementation costs will also be substantial for regulators as well as for the banking community.

Even more important, perhaps, than the direct monetary costs, are the indirect costs whether the new rules support the real risk management needs of the business, or whether they become an extra bureaucratic burden or a diversion. Banks will have to run these complex calculations regardless of whether they remain relevant as the markets evolve.

To make matters worse, the current Accord also compels banks to use the Basel II calculations in their internal management process in many areas, regardless of whether they remain relevant for business practices. If bank management is required to compute and manage by the Basel II rules anyway, further improvements in internal practice will be seen as both costly and irrelevant. As a result, the Basel Accord could actually slow the progress of better risk management techniques over time.

The Basel rules are based on the financial markets as they work today, but they are so complex and heavily negotiated, they will be difficult to update over time. This could have the effect of freezing much of the progress being made in risk management, and locking us into an early–2000's mindset, regardless of what the future brings.

Our proposed response to this problem is for the Basel Committee to place a much greater emphasis on the "Pillar II" section of the proposal. Whereas Pillar I sets out regulatory capital calculations in a detailed, prescriptive way, Pillar II is a section whereby regulators force firms to develop their own internal models and then scrutinize them through the examination

process. This "principles-based" approach has some important natural advantages vs. the complex black-letter rules prescribed by regulators under Pillar I of the proposal. Pillar II encourages banks and regulators to work together over time to improve risk management practice, rather than forcing compliance with a potentially dated rulebook. That process permits steady, evolutionary improvement and should therefore be more durable and relevant than the complex rules of Pillar I that are designed with today's markets in mind.

Addressing the cost and complexity issue will not be simple in the short time left before the rules are finalized. If these rules are all applied as black letter law and interpreted strictly, the new rules will be both costly and – since the risk management advances that lead in part to Basel II will not end in 2003 - increasingly irrelevant to real risk management We encourage an approach that emphasizes principles and simplicity as the rules are finalized and emphasizes the spirit of the new rules when assessing compliance.

Getting implementation wrong could have important implications for the level playing field, especially in the US, where non-bank competitors like investment banks, finance companies, and agencies represent a large part of the system. The Basel rules do not apply to them. If the Basel II costs are high, banks will earn a lower return on capital and therefore grow more slowly. There may even be some incentives to exit businesses or to de-bank altogether. In short, we may get a more uniformly regulated commercial banking system, but there may be fewer banks to regulate over time.

Pro-Cyclicality

The new rules will change how banks calculate and manage their capital and the amount of business they choose to do. If banks all act in concert – as they will tend to do under a common regulatory regime - this can significantly increase or decrease liquidity in the credit markets and ultimately affect the real economy. We have analyzed this effect over the last 20 years of credit cycles. Our calculations suggest that the impact on required bank capital will be substantial. In particular, the new Basel II calculations would require much more bank capital during economic recessions than the current system.

As a practical matter, consider the credit environment the last two years. We have seen huge numbers of credit rating downgrades, which have increased the real risk of bank portfolios. The current system is relatively indifferent to this change in terms of required regulatory capital, but the proposed system will require significantly more capital as companies are downgraded. Banks will have to choose between raising more capital during recessions or reducing the amount of lending that they do.

Cutting lending during a downturn is probably smart, if your perspective is focused solely on bank solvency. However, it raises significant issues for the wider economy. My personal estimate is that my bank would have cut back its lending by perhaps an additional 20% to 30% if the Basel II rules were in place during 2002. If all banks cut back at the same time, the potential adverse impact on the real economy could lengthen and deepen the recession. This process by which the rules would widen economic swings is called "Pro-Cyclicality".

We are currently in an economic slowdown; it is difficult to think that adding pressure on bank capital during this period would be helpful to economic recovery. In fact, it defeats part of the reason for regulating banks in the first place – in order to have a stable supply of capital to support the underlying economy. We need to be particularly careful here because the new system is imposed across the whole banking system and everyone will have to operate at the same time on the same rules. Herd behavior can make smaller problems into bigger ones.

The regulatory community has acknowledged this as a potentially serious issue, but I do not think the responses to date have fully addressed this issue. When the first quantitative proposals in January 2001 revealed a significant potential problem, the regulators did react with a revised and somewhat "flatter" risk-weight curve[3]. However, while this reduces the scale of the issue, it does not grasp the nettle. More recently, revised Pillar II proposals have added "stress tests" which can give rise to additional capital requirements[4]. The exact design of these tests is unclear but the language suggests they amount simply to an extra layer of buffer capital so that we will not need to dig into capital in tough times. In effect, this is like creating a second fire department, so that the first fire department never has to go to work. Creating two fire departments or requiring two pools of capital is expensive and doesn't seem to address the fundamental issue. That issue is that a risk sensitive system will inevitably lead to varying capital requirements through time, and that is a result that will require explicit management and thoughtful preparation. As with other areas of the Basel Accord, adding some flexibility to the rules is the simplest and most practical way of preventing these inevitable stresses from building up into major crises.

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[3] Basel Committee on Banking Supervision, Working Paper "Potential Modifications to the Committee's proposals", Bank for International Settlements, November 2001.

[4] Basel Committee on Banking Supervision, Quantitative Impact Study 3 Technical Guidance, Bank for International Settlements, October 2002. Paragraph 381.

Operational Risk

In addition to its credit risk reforms, Basel II also focuses on Operational Risk – the risk of breakdowns in systems and people. While a more refined approach to credit risk has considerable merit, the proposed quantification of Operational Risk is, in my view, ill considered, wasteful and possibly counterproductive. It would be great to quantify and control all such risks with statistical methods; however there are fundamental reasons why Operational Risk will be difficult to measure in this way. Consider a comparison of Operational Risk to credit risk.

- In credit risk, we can measure our positions and maximum loss precisely. We create exposures only when we choose to, and so we know how much exposure we have.
- We can estimate the risk of each position via credit ratings or other techniques, and test these against a long history of how those ratings behave in different environments.
- Lastly there is market pricing for credit risks, so we have price signals to back up these estimates.

When you add all this up, I think there is real substance behind taking a more advanced approach in measuring credit risk. While it would be desirable to quantify Operational Risk in a similar fashion, it simply does not share any of the properties that help measure credit risk. Nobody "chooses" to have more fraud risk or more IT risk, and it is difficult to estimate what the maximum loss might be or how likely they are. It is difficult, if not impossible, to predict the risk of disasters and acts like the 9/11 tragedy, but that is what this part of the reform attempts to do.

In fact, I have yet to see anything substantial that suggests that Operational Risk is measurable in a way that is similar to market or credit risk. There have been insistent demands for "progress", and a "scientific approach", suggesting that the problem could be solved if we just tried a bit harder. Many of these efforts focus on trying to find small areas, such as processing losses that happen to be susceptible to statistical techniques, and trying to extrapolate these results to cover all other risks. But these issues are not generally relevant to major risks, such as fraud, a changing legal environment, or a major disaster. Operational Risk in capital terms is the risk of being fundamentally surprised. Yet it is difficult to predict and measure what you don't expect.

I am a model-oriented, technical person by training, but I do not want to be forced to rely on a model that is built on fundamentally flawed assumptions. I am highly skeptical that the intellectual foundations for this can be built on solid ground.

Basel II and other regulatory initiatives will push banks to spend a lot of money on Operational Risk systems and loss databases, but I personally feel that much of that money will be wasted. In fact, we may be creating a real danger – creating a false sense of security that we have measured Operational Risk and hence controlled it. I worry that we will all be a bit embarrassed if this emperor is shown to have no clothes.

Recent information from the Basel Committee has been somewhat encouraging in this area – it suggests an increased degree of flexibility in Operational Risk calculations[5]. I am hopeful that this will bear out through the final Basel drafting as well as through national implementation. But we will still have a long way to go, and I am concerned that we are likely to see some backsliding into prescriptive black-letter rules when regulators have to develop specific requirements for model approval.

[5] Basel Committee on Banking Supervision, Quantitative Impact Study 3 Technical Guidance, Bank for International Settlements, October 2002.

Pillar III – Disclosure Rules

One of the strengths of the Basel II proposals is that they look beyond just calculating and maintaining capital levels. In designing Basel II, regulators realized that capital requirements-- the so-called "Pillar I" - could never ensure the safety and soundness of the banking system alone. They understood that ultimately it is more important to encourage constructive relationships between financial institutions, their supervisors and the market to produce good risk management. This reasoning, which has the strong support of the banking industry, has lead to the creation of the two qualitative Pillars of the Basel Accord: Pillar II (Supervisory Review) and Pillar III (Market Discipline).

The concepts behind the proposed rules for Pillar II and III are well accepted by the industry and regulators alike. However, many of the detailed proposals are cause for alarm in the industry, particularly in the Pillar III market disclosures section. Unfortunately, the development of Pillar III is an area where there has been little genuine consultation between the industry and the regulators, in contrast to Pillar I. I believe the proposals reflect this in a somewhat one-sided view of the risk profiles of financial institutions and the needs of their stakeholders.

We currently publish approximately 20 pages of risk information in our annual report, and we support transparency and disclosure as very worthwhile goals. The Pillar III proposals would add a large mass of additional disclosure which are highly technical in nature and which we believe will be of little benefit to the reader. We estimate that they would add another 20 to 30 pages to our annual report, more than doubling the current weight of disclosure on risk. Indeed, few people are able to digest all of the information that is already presented on risks, but now this information will could be lost in a deeper, more technical pile of data. The additional requirements proposed under Pillar III are more likely to confuse than illuminate.

Of particular concern are the numerous required disclosures that relate directly to the capital calculations performed within Pillar I. Instead of disclosing measures of risk used in internal risk management systems, these disclosures fix an explicit regulatory capital view of risk. In the most complex areas, such as asset securitization, these disclosures will surely be

mystifying to all but the most expert audiences. Moreover, given the likely longevity of the Basel II Accord (the current Accord is in its 14^{th} year), there is a need to ensure risk management practice is able to mature beyond the concepts now embedded in the Basel II proposals.

Just as the market has moved beyond the current accord, there will inevitably come a time when some Pillar I calculations are no longer regarded as good measures of risk for all products. In that case, it must be possible for banks to alter disclosures to represent emerging best practices. Under Pillar III as currently proposed, banks will likely find themselves constrained to disclosing risks under a system that is no longer wholly relevant.

In designing the details of Pillar III, the Basel Committee has placed too much emphasis on quantity, rather than quality, of disclosure. It is emphasizing consistency by prescription instead of consensus. The Committee has ignored the successes of market consensus in recent years. For example, the demands of the market have produced broadly comparable and largely voluntary disclosures of market risk by banks. This is an example of how Pillar III should work. It would be more effective if Pillar III established a general set of principles, and then allowed the discipline of the market to produce continuous improvement in risk disclosure. This would produce information that the market actually desires, rather than seeking to impose today's ideas on future market participants by fiat.

Summary

We are at an important crossroads in the reform effort. A lot of good hard work on designing the framework and gaining political consensus has been accomplished. We have a high regard for the efforts of the Committee, and CSFB has tried to contribute to that discussion in a constructive manner. But unless the current edifice can be significantly streamlined, we risk that this project will be seen as a step back rather than a step forward.

Simplifying the massive weight of detailed rules in Pillar I will require much discipline in the next round of drafting. It is always easier to accept a bit more complexity to address specific issues as they come up, but that approach eventually leaves you with a very complicated, costly, and potentially out-of-date system.

It will also require a strong emphasis on the "spirit" of the rules when these rules move to the implementation phase with national regulators. If these rules are interpreted as black-letter regulations, each to be set to a highly technical audit standard, the costs of implementation will be high. Such an approach would mean the calculations would also become increasingly outdated and less relevant to good risk management over time. We can hope that all national regulators will avoid this pitfall, but as an international bank, we will still have to conform to the standards set by the strictest and most literal of our major regulators.

As a final comment, I believe that much more can be accomplished by increasing the emphasis on the concepts of Pillar II and Pillar III, and a focus on principles, rather than formulae. We should reduce reliance on the complex formulae of Pillar I and the overly prescriptive elements of the other pillars. This approach would not only help address "complexity, cost and adaptability", but could also help address the issues of Operational Risk and pro-cyclicality.

Pillars II and III have real people on the other side – regulators and the market. Real people can adapt to changes and new markets more easily than a rulebook can. These pillars, properly applied, also put the burden back where it should be – on the shoulders of bank management to demonstrate to the regulators and the public that they are doing a good job. That

is in the spirit of the Sarbanes-Oxley reforms, and I think it is a smart, durable way to improve discipline.

Lastly, it should also make the new system more responsive to change and therefore more relevant over time. Without these added benefits, I am afraid we might have to start work on a Basel *III*, well before we have had a chance to recover from the current effort.

Thank you.

Appendix 1. Example of complexity in the proposed Basel rules

The below is a summary of the proposed formula (the "Supervisory Formula" or SFA) for calculating capital for asset securitizations[6]. This formula applies to certain securitizations; in addition the rules specify at least three sets of risk weights based on credit ratings which must be used in certain other circumstances; these are not shown.

- Capital calculation under the SFA
  - For a securitization tranche of *support* L (the total notional of more junior tranches) and *thickness* T:

$$\text{Capital} = S(L+T) - S(L)$$

  - where

$$S(L) = \begin{cases} L & L \le K_{IRB} \\ K_{IRB} + K(L) - K(K_{IRB}) \; + d.K_{IRB} / \omega(1 - e^{\omega(1 - L/K_{IRB})}) & K_{IRB} < L \le L^* \\ S(L^*) + (L - L^*) \times floor & L^* < L \end{cases}$$

  - where

Cumulative beta distribution functions

$$K(L) = (1-h)(1 - B_{a,b}(L))L + B_{a+1,b}(L)c$$

  - and

$$a = g.c$$
$$b = g.(1-c)$$
$$c = K_{IRB} / (1-h)$$
$$d = 1 - (1-h)B_{a,b}(K_{IRB})$$
$$h = (1 - K_{IRB})^N$$
$$f = \frac{v + K_{IRB}^2}{1-h} + \frac{K_{IRB}(1 - K_{IRB}) - v}{(1-h)\tau}$$

$$N = (\sum_{\text{assets in pool}} EAD)^2 / \sum_{\text{assets in pool}} EAD^2$$
$$LGD = 45\%$$
$$v = \frac{K_{IRB}(LGD - K_{IRB}) + \frac{1}{4}(1 - LGD)K_{IRB}}{N}$$
$$g = \frac{(1-c)c}{f} - 1$$

- Significance of the parameters
  - K_{IRB} is the on-balance sheet total pool capital charge as a % of pool notional.
  - N is the "effective" number of assets in the pool.
  - LGD is average loss given default estimate for the pool; = 45% in foundation IRB approach.
  - ω is present to give a continuous marginal rate of capital. τ is present to account for "uncertain loss prioritization" These parameters will be ω = 20 and τ = 1000 per WPII, November 2002.

[6] Basel Committee on Banking Supervision, Quantitative Impact Study 3 Technical Guidance, Bank for International Settlements, October 2002. Paragraph 573.

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Statement by

Roger W. Ferguson, Jr.

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic and International Monetary Policy, Trade and Technology

Committee on Financial Services

House of Representatives

February 27, 2003

Chairman King, Congresswoman Maloney, members of the Subcommittee on Domestic and International Monetary Policy, Trade and Technology: It is a pleasure to appear before you this morning on behalf of the Board of Governors of the Federal Reserve System to discuss Basel II, the evolving new capital standard for internationally active banks and bank holding companies. At this time, bank supervisors in this country and abroad are evaluating the results of a recent survey to assess the potential quantitative impact of the current proposals on the world's large banks. In addition, the supervisors in the United States are still incorporating feedback from our discussions with bankers, an ongoing process that will continue even after final rules are adopted. From the U.S. perspective, a hallmark of the Basel II process has been the effort to tailor the capital framework to the evolving industry best practices. We intend for these dynamic efforts to continue.

That having been said, after almost five years of discussion and revision, Basel II is about ready for the last rounds of comment--which we anticipate this spring and summer. We expect the Basel Committee to approve its package by late this year, the corresponding U.S. rulemaking process to be completed next year, and implementation to begin in late 2006. Banks need some certainty for planning, but this is not inconsistent with further changes between 2004 and 2006, and thereafter, as we learn more and as practices evolve.

Why Is a New Capital Standard Necessary?

The supervisors in this country have determined that Basel I, the current capital regime adopted in 1988, must be replaced for the most complex banks for three major reasons: defects in Basel I as it applies to these large entities, evolution in the art of risk management, and increased heterogeneity and concentration in the banking system.

Defects in Basel I. Basel I was a major step forward in capital regulation. Indeed, for most banks in this country, Basel I is now--and for the foreseeable future will be-- more than

adequate as a capital framework. Most banking institutions in this country engage in businesses with risks that counterparties and supervisors can evaluate relatively easily. Moreover, because of their lack of geographical diversification and/or limited alternative funding sources, the market continues to force most banks to carry capital positions considerably in excess of regulatory minimums under Basel I. For these reasons, U.S. supervisors do not believe the benefits would exceed the costs of requiring most banks to shift to Basel II. However, for the small number of large, complex, internationally active banking organizations, Basel I has serious shortcomings, which are becoming more evident with time. Developing a replacement to supply to these banking organizations is imperative.

First, Basel I is too simplistic to adequately address the activities of our most complex banking institutions. Basel I categorizes each bank's assets into one of only four categories, each of which represents a certain risk class. Each risk class has its own risk weight that is multiplied by 8 percent to get the minimum capital charge: zero for most sovereign debt, 20 percent of 8 percent for most intra-bank exposures and for agency securities, 50 percent of 8 percent for residential mortgages, and 100 percent of 8 percent for all other exposures. These "all other" credits include essentially all corporate and consumer loans, meaning that the whole spectrum of credit quality over which banks do much of their lending--from Aaa to the most speculative credits--receives the same regulatory capital charge. The lack of differentiation among the degrees of risk means that the resultant capital ratios are too often uninformative and might well provide misleading information for banks with risky or problem credits or, for that matter, with portfolios dominated by very safe loans.

Moreover, the limited number of risk classes not only limits the value of the capital requirement but also creates a regulatory loophole that creates incentives for banks to game the system by capital arbitrage. Capital arbitrage, in this case, is the avoidance of certain minimum

capital charges through sale or securitization of those assets for which the capital requirement that the market would impose is less than the regulatory capital charge. Clearly, the market believes that the 4 percent capital charge on most residential mortgages (50 percent of 8 percent) and the 8 percent on most credit cards (100 percent of 8 percent) is higher than the real risk, facilitating the securitization and sale of a large volume of such loans to other holders. This behavior is perfectly understandable, even desirable in an economic efficiency sense. But it means that banks that engage in such arbitrage retain the higher-risk assets for which the regulatory capital charge--calibrated to average quality assets--is on average too low.

Supervisors, through the examination process, are, to be sure, still able to evaluate the true risk position of the bank, but the capital ratios of the larger banks are becoming less and less meaningful, a trend that will only accelerate. Not only are creditors, counterparties, and investors less able to evaluate the capital strength of individual banks from what are supposed to be risk-based capital ratios, but regulations and statutory requirements tied to capital ratios have less meaning as well.

The Evolving State of the Art. At the same time, risk management and appropriate capital determination have evolved significantly beyond the state of the art at the time Basel I was developed. Banks themselves have developed and adopted some of the new techniques to improve their risk management and internal economic capital measures. But clearly banks can go considerably further. Basel II would speed adoption of these new techniques and promote the future evolution of risk management by establishing a framework that is more risk-sensitive.

Increased Heterogeneity and Concentration in Banking. Finally, market pressures have led to consolidation in banking around the world. Our own banking system has not been immune; it, too, has become increasingly concentrated with a small number of very large banks operating across a wide range of product and geographic markets. Their operations are

tremendously complex and sophisticated, and their significantly different strategies add a high degree of heterogeneity to their operations. At the same time, significant weakness in one of these entities, let alone failure, has the potential for severely adverse macroeconomic consequences. It seems clear that the regulatory framework should encourage these banks to adopt the best possible risk measurement and management techniques while allowing for the considerable differences in their business strategies. Basel II presents an opportunity for supervisors to encourage these banks to push their management frontier forward. Of course, change is always difficult, and these new mechanisms are expensive. But a more risk-sensitive regulatory and capital system would provide stronger incentives to adopt best practice internal risk management.

Let me be clear. If we do not apply more risk-sensitive capital requirements to these very large institutions, the usefulness of capital adequacy regulation in constraining excessive risk-taking at these entities will continue to erode. Such an erosion would present U.S. bank supervisors with a highly undesirable choice. Either we would have to accept the increased risk of instability in the banking system, or we would be forced to adopt alternative--and more intrusive--approaches to the supervision and regulation of these institutions.

Basel II

I want to stress that the U.S. supervisory authorities intend to apply only the so-called Advanced Internal Ratings Based (A-IRB) version of Basel II. We will *not* be adopting the two other variants of Basel II--the Standardized and Foundation Internal Ratings Based Approaches--that have been developed by the Basel Committee. We expect to *require* about ten large U.S. banks to adopt the A-IRB approach, but we anticipate that a small number of other large entities will *choose* to adopt it as well after making the necessary investment to support their participation.

All other banks in this country will remain on the current Basel I capital standard when the new Accord is implemented. For these thousands of banks, the shortfalls of the current rules, as noted, are not sufficiently large to warrant a mandatory shift to the Basel II regime. However, any of these institutions will have the option to adopt the A-IRB requirement, as we expect some large entities to do at the outset. If they seek to do so, however, they will have to meet the same high standards of internal infrastructure and controls that will be required of the core group.

The Federal Reserve Board believes that the A-IRB approach of Basel II will address the material defects of Basel I for these entities. By requiring strong internal standards as an entry criterion, the Basel II approach will ensure that these banks adopt structured, formal, empirically based methods of managing credit risk, which will lead to significantly improved risk-management capabilities at the very largest banks and other adopters. Capital requirements themselves will become more risk sensitive and less prone to artificial distortions. The poor incentive structure of Basel I will be removed for A-IRB banks. Supervisory practices will also become more consistent with evolving risk-management practices. Risk-based capital ratios will become more reliable as an indicator of financial strength.

I turn now to another aspect of Basel II: its three pillars. At the outset of the Basel II process, the supervisors on the Basel Committee determined that a robust capital adequacy framework should include three important elements or pillars. Pillar I consists of the minimum capital requirements themselves--that is, the rules by which a bank calculates its capital ratio and by which its supervisor assesses whether it is in compliance with the minimum capital threshold. Pillar II, the supervisory oversight pillar, encompasses the concept that well-managed banks should seek to go beyond simple compliance with minimum standards and perform for themselves a comprehensive assessment of whether they have sufficient capital to support their risks. In addition, supervisors should be in a position to provide constructive feedback to bank

management on these internal assessments, or "economic capital", based on their knowledge of industry practices at a range of institutions. Finally, Pillar III seeks to complement these activities with market discipline by requiring banks publicly to disclose key measures related to their risk and capital positions. The concept of these three mutually reinforcing pillars has been key to the Basel II effort.

Pillar I: Minimum Regulatory Capital Requirements. The minimum capital requirements for credit risk under the A-IRB approach are built around the same concepts that underlie all modern portfolio-based methods for systematically measuring credit risk. The first, and perhaps most important, input to this approach is an estimate of the likelihood or probability that a borrower will default. Second, lenders need a sense of the size of the loss in the event of a default because they are often able to recover something from a defaulted borrower's assets or from collateral or a guarantee. Third, the lender, who often has an undrawn credit line or loan commitment to a borrower, needs to estimate what the amount borrowed is likely to be at the time a default occurs. These key inputs--probability of default (PD), loss given default (LGD), and exposure at default (EAD)--are the building blocks of the A-IRB approach to estimating capital requirements. Many banks are currently working to improve their ability to estimate these quantities, using a wide variety of techniques from expert judgment methodologies to quantitative statistical models.

A-IRB permits banks to use any or all of these, requiring only that the procedure for estimating these three key parameters be based on empirical information, that it be rigorous, that it be reproducible by third parties, that the process be subject to strong internal controls, and that the results be shown to measure risk accurately. The supervisor must, in fact, validate the estimation procedures and the controls that support them before a bank can use A-IRB. As part of the validation process, a bank must demonstrate that these risk measures are in fact used in

credit-granting decisions, as well as for other management purposes such as reserving and pricing. The intention is for the supervisor and the manager to focus on the same issues.

These estimated risk variables are inputs to regulatory formulas that will determine the minimum required capital for a given portfolio of exposures. Just as the methods of determining the inputs can change as the state of the art changes, the formulas that translate the inputs into capital requirements can be modified as well by the regulators. Basel II can improve as knowledge improves.

The rules surrounding Pillar I are clearly more complicated than I have just described, and the volume of comment letters and the number of pages that have been and will be published for comment will attest to that. One reason for that complexity is that the large, complex banking organizations, to which the rules are addressed are, in a word, complex. Simple rules just cannot address their issues and the nature of their business. These rules have been adjusted and modified significantly as a result of comments from bankers and other interested parties. Sometimes those comments have led to simpler rules. But, more often, they have led to even more complex rules because each complex bank to which they apply operates somewhat differently from other banks. Thus the rules have been modified to address important and meaningful differences in risk. Simple rules too often become straightjackets; flexibility requires more complex rules.

Pillar II: Supervisory Oversight. Indeed, because even complex rules cannot adequately capture the risks and desirable procedures for each bank, the A-IRB establishes with Pillar II a mechanism for dialogue on risk and capital between bank managers and bank supervisors. I have already noted that supervisors will verify the process for determining credit-risk measurement, for ensuring ongoing control over the process of determining these risk-measure inputs, and for ensuring that the risk inputs are used for more than calculation of regulatory

capital. In addition, Pillar II requires that the bank maintain its own internal assessment of its risk relative to its capital--both currently and over the cycle as well as in periods of stress--*and* that the supervisor review and respond to that assessment. The focus is on ensuring that the bank has strong risk-assessment capabilities and that the supervisor and the bank jointly assess and evaluate that capability.

This kind of dialogue cannot be captured by any set of rules. It will focus on a frank discussion of loss potential and of any unusual capital needs associated with unbundled risks not captured in Pillar I. It addresses the individual bank's special risk profile, its special business strategy--which might, for example, imply geographic or borrower concentrations--or its unique cyclical sensitivities. Such discussion, review, and analysis are focused on the individual bank's possible unique need for a capital buffer--an amount in excess of its Pillar I minimum. Such buffers are designed to minimize the risk that losses and capital erosion could trigger undesired responses under prompt corrective action and the associated reactions that could affect financial and real macroeconomic stability.

Pillar II, we should be clear, has some drawbacks. It is inherently less transparent than Pillar I because outsiders will not know which portion of a bank's excess capital is deemed "necessary" to address a particular risk specific to the bank and which portion is truly an "extra" cushion. It is also more difficult--although not impossible--for supervisors to require an uncooperative bank to hold Pillar II capital than rule-imposed Pillar I capital.

Pillar III: Market Disclosure. Basel II seeks to minimize the public difficulty of interpreting capital ratios by requiring public disclosure of considerable quantitative and qualitative information, including, in effect, the risk inputs I described earlier. Such disclosures also provide incentives for banks--the disclosers--to adopt better risk-management techniques and to link their capital requirements to their risk profiles. All these results will enable the public to make comparisons among banks more easily. Indeed, the ability to compare will be an important constraint on any supervisor, foreign or U.S., who might not diligently apply the rules to its banks; outliers will appear unusual and, with insufficient explanation, be subject to market discipline.

Indeed, a key reason for Pillar III is to seek to harness market discipline to bring pressure on banks to adopt safe and sound practices. Public disclosure increases market discipline in two ways. First, by providing more information, it enables the market to impose differential funding costs and availability on banks, related to the risks they take; additional risk requires additional Pillar I capital, but the disclosure of that risk and the size of the capital buffer also affects the minimum price that counterparties require to provide funding. Second, as noted, it facilitates comparisons across banks. Because outliers will be subject to particularly close review by the market and other national regulators, banks and their regulators will have more difficulty evading their minimum capital requirements.

Key Issues

Not surprisingly with such a significant proposal, some are concerned about certain aspects of Basel II. It might be useful to the subcommittee if, in the remainder of my comments, I focus on a number of issues that have been raised. Before I do, however, I want to reiterate to the subcommittee that the process of developing the Basel II proposals has involved a truly unprecedented dialogue with banks on a wide variety of issues. That dialogue is still going on,

especially with regard to technical issues involving retail credit, risk-mitigation techniques, securitization, and other matters, including some that should be called to your attention.

Operational Risk. One of the early decisions by the participants in the Basel II process was to focus more clearly on credit risk in the capital determination process. Doing so required that all the other risks that had been combined with credit risk in Basel I be unbundled. Several years ago, the first necessary step in the unbundling of these risks was taken when the market risk of trading activities was separated for its own treatment. The Basel II effort has focused very carefully on the credit risks that banks take and has sought to ensure that the framework appropriately measures the marginal contribution of such risks to a bank's total risk profile. But this focus implies the need to consider the way to address other important banking risks. Some of these risks are sufficiently modest that they can be addressed through the supervisory process--Pillar II. But one risk, operational risk, has been historically so important in the depletion of capital and the failure of banks that it should be subject to specific Pillar I minimum capital requirements.

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, and it includes legal and compliance-related risks. These risks and their associated losses are often in the news: rogue traders, fraud and forgery, settlement failures, inappropriate sales practices, poor accounting and lapses of control, troubles in acting as custodians and managing assets, and legal settlements involving significant payments for losses alleged to have been caused by banks. All of these costs have been substantial both here and abroad.

Indeed, many banks, in their internal economic calculations, already allocate a significant portion of their capital for operational risk--averaging 17 percent in the subset of large banks we sampled. A couple of banks even make the amount public, and increasingly the market is

sensitive to the fact that not all excess regulatory capital is held just as a general buffer, that is, that excess *regulatory* capital is not necessarily excess *economic* capital. But the public is unable in most cases to differentiate the excess regulatory capital held for specific purposes from that held for general purposes. This inability is a particular problem under Basel I for those entities with modest credit risk and dominant operating risk. Under Basel I, the regulatory capital is driven solely by credit risk, and therefore the requirement tends to be too low for activities that do not entail much credit risk but do expose the bank to operational risk. The A-IRB banks under Basel II that specialize in such activities--for example, processing securities and payments and acting as custodians--will experience increases in their *regulatory* capital requirements on those activities. Every day these entities transfer very large amounts of federal funds, act as custodians for massive quantities of securities, and dominate payments and securities transfer systems. Disruptions in their operations can cause, and have caused, serious difficulties in world financial markets.

U.S. supervisors will propose that those banks that are required, or that choose, to adopt the A-IRB approach to Basel II will also be required to hold capital for operational risk, using a procedure to develop the size of that charge known as the advanced measurement approach (AMA). Because of earlier comments by U.S. bankers, the amount of required operational risk capital will not be subject to a minimum floor nor will the charge be based on revenue. Rather, under the AMA, A-IRB banks themselves will have the primary responsibility for assessing their own operational risk capital requirement. This requirement will be a Pillar I charge and will be disclosed to market participants under Pillar III. The banks that remain under Basel I will not be subject to an operational risk capital charge in the United States.

The advanced measurement approach gives banks the flexibility to develop their own methodology for calculating the operational, or "op", risk capital charge. The supervisor, to be

sure, will require that the procedure be comprehensive, systematic, and consistent with certain broad guidelines. These guidelines specify such factors as the necessity for independent risk management, board and senior management oversight, audits, the use of historical internal and external loss data, scenario analysis, and so forth. The supervisor must review and validate each bank's process, but again considerable flexibility exists for individual bank application. The op risk capital charge is expected to reflect banks' own environment and control mechanisms and can be reduced by insurance and other risk mitigants. For example, if a bank invests in improved contingency procedures and approaches, we would expect such an investment to be reflected in a reduction in the need for operational risk capital under the AMA.

Several U.S. banks that are developing an op risk capital requirement under the advanced measurement approach have told us that they are very comfortable with the results so far. Importantly, they say that the procedures have allowed them to better identify business activities and practices that pose operational risks and that they have taken steps to minimize the risks. That result is critical to supervisors who believe that the AMA methodology will produce a lasting discipline for banks, encouraging them to think carefully about and minimize the risks associated with their business activities. Supervisors expect the advanced measurement approach to provide the incentives to invest in new systems and practices that will reduce the potential for serious losses from operational risk.

Operational risk and the AMA are issues that I call to the subcommittee's attention because I am aware of a very few banks that aggressively oppose this aspect of Basel II. Accordingly, I have held a number of discussions with bankers on this subject over the last year, including many direct conversations with the senior bankers who have expressed the most concern about the issue. As I indicated earlier, I believe this sort of dialogue has been essential to the appropriate development of the Basel II framework and is something that we will continue

to emphasize. But as a bank supervisor and as a central banker, I have to say that we have not found the arguments of the operational risk skeptics to be convincing.

The skeptics argue that the cost of developing and using the advanced measurement approach and the associated capital charges divert resources away from actual investment in risk-reducing systems and better backup systems. As I will discuss more fully, Basel II, without doubt, is costly; but the final judgment for any expenditure must rest on the balance between costs and benefits. We and, as noted, many banks believe that the AMA is critical for the kind of formal analysis that focuses banks' attentions on the operational risks they face. We are also convinced that the explicit Pillar I capital charge creates incentives for them to reduce these risks while ensuring that minimum capital is allocated to absorb the remaining risk.

Critics also argue that an explicit Pillar I capital charge would upset the competitive balance with nonbank and foreign bank competitors. Foreign regulators, it is argued, will be less aggressive in their rule enforcement than U.S. regulators. As I earlier suggested, Pillar III--disclosure--will highlight any significant differences across banks, in the expectation that counterparties will penalize inconsistent risk measures. In addition, the Basel Supervisors Committee has set up an implementation group of senior supervisors to coordinate the application of the rules across countries.

As for nonbanks, the argument ignores the significant edge banks will continue to have from access to the discount window and the Federal Reserve's payments system. This competitive edge attracts customers and lowers funding costs relative to nonbanks. In addition, most of the banks that have expressed concern about the operational risk capital charge are already carrying large excess regulatory capital positions, supplementing their quite small current regulatory capital. Indeed, we do not believe that these entities would have to raise any new capital to meet the proposed op risk charges, but rather would simply shift excess to required

capital. “Excess” *regulatory* capital may be reduced for some banks under Basel II, but we believe that such reductions because of op risk are perfectly consistent with making capital requirements both more risk sensitive and more transparent, not to mention more accurate.

The effort not to raise regulatory capital requirements is underlined by the critics' preference that op risk capital needs be addressed in Pillar II--that is, it should be part of the undisclosed capital buffer developed as part of the supervisory oversight of banks on a case-by-case basis. We again disagree. Excess regulatory capital would appear larger than it should, and the transparency of the proposed procedure would be lost. Inevitably, such an approach would treat banks with similar risks differently. Supervisors would also have less leverage over a bank's capital allocation for op risk and third parties would have more difficulty comparing capital among banks than they would under a Pillar I rule.

In short, we have not been convinced by the arguments we have heard, and we still believe that op risk is every bit as real a risk as credit risk and should be treated in the same way--with an explicit Pillar I capital charge.

Commercial Real Estate. Some banks--mostly those that would not be subject to the A-IRB capital requirements unless they chose to become so--oppose the higher capital charges that A-IRB banks would generally face on their commercial real estate loans. These banks argue that bank lenders have learned from the losses of the 1980s and early 1990s and now do much better underwriting by insisting on more borrower equity and better appraisal procedures for commercial real estate. These improvements, critics argue, have reduced default rates and losses and, if anything, argue for lower, not higher, capital requirements or at least the same capital charge that is applied to business loans under A-IRB.

Setting aside that the system has not been tested by a true real estate cycle since the early1990s, the supervisors agree that commercial real estate underwriting has significantly improved. These improvements have been incorporated into the empirical analysis that our staff has used in developing the Basel II proposals. In the view of the Federal Reserve, however, capital requirements should be based on more than just the chance that an individual loan will default: They should also be based on the tendency of defaults to occur at the same time, in "clumps"--what economists refer to as high asset correlation. Defaults and losses occurring in clumps require higher capital than such losses spread out over time. According to our analysis, this clumping tendency is much stronger for commercial real estate credits than for business loans. Moreover, though improvements in underwriting have made individual loans safer, the asset correlations among such loans in a given portfolio--the "clumping" tendency--has not changed as a result of improved underwriting.

The staff of the Federal Reserve has discussed this issue with bankers and has shown them an analysis--based on several data sets and using different methodologies--requesting their evidence of any errors or new data sets that challenge the staff's conclusion. The Federal Reserve is in the process of making this analysis widely available and is again asking for critical evaluation and any contradictory information. We are, in short, willing to listen. If banks can provide evidence that this proposal embodies erroneous assumptions or is otherwise analytically faulty, we will change it.

Cost. Implementing A-IRB in this country is going to be expensive for the small number of banks for which it will be required, for those banks choosing it, and for the supervisors. For the banks, the greatest expense is in establishing the mechanisms necessary for a bank to evaluate and control their risk exposures more formally. Nonetheless, such costs are modest relative to the size of recent charge-offs. The A-IRB approach will not eliminate losses: Banks are in the business of taking risk and where there are risks, there will be losses. But we believe that the better risk-management that is required for the A-IRB will reduce losses and provide benefits to bank stakeholders and the economy. The cost-benefit ratio looks right.

Furthermore, attributing all the costs associated with adopting modern, formal risk-management systems to Basel II is a logical fallacy. The large banks required to adopt A-IRB--banks that must compete for funding in a global marketplace--would ultimately have to undertake such measures with or withou' Basel II. Basel II may well speed up the adoption process, but many of the costs attributed to Basel II actually just reflect the costs of doing business in an increasingly complex financial environment.

Competitive Equity. Some regional banks have told us that they are concerned that regional, and perhaps smaller, banks will be competitively disadvantaged by Basel II, even if they are not required to adopt A-IRB. Their concern has two parts.

First, some regional banks feel that market pressure and the rating agencies will force them to adopt A-IRB and, as a result, to incur significant costs. Our discussions with rating agencies do not support the regional banks' fears. Indeed, our sense is that the rating agencies feel that adoption of A-IRB by regional banks at this time would not be cost effective. In our opinion, any regional bank interested in adopting the A-IRB approach at its inception should carefully assess the costs and benefits of doing so.

That said, we expect the art and science and, indeed, the very language, of risk management to migrate toward that used for A-IRB. Over the years ahead, as the new risk-management techniques become more cost effective for them, regional banks, we suspect, will adopt these techniques and, thereafter, probably adopt the A-IRB at the regulatory level. But adopting them now would be premature, and we believe that regional banks will not be pressured to do so by either the rating agencies or the regulators.

The second part of the competitive equity concern is the belief by some regional and community banks that they will be placed at a competitive disadvantage with A-IRB banks because of the larger banks' lower regulatory capital charges on residential mortgages, loans to smaller businesses, and certain retail loans.

The direct competitive impact on Basel II and Basel I banks is important. Of course, the rulemaking process in the United States will probe the issue fully. However, a number of factors suggest that the concern about competitive impact is not well founded.

In terms of *overall* capital, A-IRB banks will likely face lower capital charges for some types of lending, but they will also face higher charges on other loan categories, such as commercial real estate finance and higher costs of developing the risk-management infrastructure to be an A-IRB bank. They will also be subject to an explicit capital charge for operational risk and the cyclical buffer in Pillar II that will not be imposed on non-IRB banks.

In the *individual loan markets* for which Basel II lowers A-IRB capital charges, we also have reason to believe that competitive balance will not be disrupted. In the business loan market, for example, the smallest banks do not directly compete with the banks that will be required to adopt A-IRB. Small banks' close ties to local communities afford them substantial information advantages over larger banks. As a result, they tend to focus on relationship lending to small businesses and individuals. A-IRB banks, in contrast, tend to make such retail loans by using automated underwriting tools. Larger regional banks are more likely to compete directly with A-IRB banks, but for two good reasons we believe that Basel II will not affect these banks significantly.

First, today not regulatory capital but economic capital--the individual bank's management judgment about internal capital allocations for its own decisionmaking--drives loan pricing and origination decisions. Nothing in Basel II will change for the capital charges implied by economic capital. Moreover, for some years, as I discussed earlier, when there has been a difference between regulatory and economic capital, sophisticated banks have used capital arbitrage techniques to reduce their effective regulatory minimums. Asset securitization deals, in particular, have allowed banks to dramatically reduce the amount of capital they currently hold for residential mortgages and many retail loans. Regulatory capital arbitrage--market reality--thus has already reduced the effective capital charge for the loans for which A-IRB banks will receive lower on-balance capital charges. Basel II increases transparency by bringing regulatory minimums more in line with reality, but it will not change the *status quo* competitive environment very much, if at all. In short, Basel II will bring A-IRB banks' regulatory capital charges more in line with the capital charges they have, through arbitrage, already obtained.

The second reason minimum regulatory capital requirements are unlikely to significantly affect competitive behavior is that most well managed banks carry sizable excess capital buffers.

Smaller banks in particular, operating with less leverage than larger banks, hold substantial excess regulatory capital, which reflects their lack of diversification and more limited access to funding. Basel II will not change that fact. Under Basel II, small banks will continue to hold more capital than A-IRB banks, but A-IRB banks' true risk-based capital positions will be measured more accurately.

Conclusion

The Basel II effort reflects the collective judgment of the supervisors of the world's largest and most complex banking organizations, including those of the United States, that the activities and practices of such firms have been outgrowing our existing supervisory approaches. At the same time, the role of these banks in our financial systems continues to grow. In my judgment, we have no alternative but to adopt, as soon as practical, approaches that are appropriately suited to the task of bank supervision of our larger banks in the twenty-first century.

The Basel II framework is the product of extensive multiyear dialogues with the banking industry regarding state-of-the-art risk-management practices in every significant area of banking activity. Accordingly, it provides a roadmap for the improved regulation and supervision of global banking. Basel II will provide strong incentives for banks to continue improving their internal risk-management capabilities as well as the tools for supervisors to focus on emerging problems and issues more rapidly than ever before.

I am pleased to appear before you today to report on this effort as it nears completion. Open discussion of complex issues has been at the heart of the Basel II development process from the outset and no doubt will continue to characterize it as Basel II evolves further.

For Release Upon Delivery
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TESTIMONY OF

JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

of the

COMMITTEE ON FINANCIAL SERVICES

of the

UNITED STATES HOUSE OF REPRESENTATIVES

February 27, 2003

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman King, Congresswoman Maloney, and members of the Subcommittee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision (Basel Committee), and the policy implications and effects these revisions will have on domestic and international banking systems. I welcome the efforts of the Subcommittee to focus attention on these critical issues. Given the importance of the U.S. commercial banking system to our domestic economy, it is essential that any regulatory changes that might affect our banking system's financial condition and competitiveness be fully understood and considered by the banking industry, the U.S. Congress and the American public.

The 1988 Accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards for commercial banks in all of the G-10 countries, and has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

Over the past several years, the Basel Committee has been developing a more detailed and risk sensitive capital adequacy framework to replace Basel I. The OCC and the other U.S. banking agencies expect to revise U.S. risk-based capital regulations to reflect the primary components of the Basel Committee's new capital adequacy framework (Basel II), but before doing so, the agencies will publish proposed revisions for public comment. Let me be absolutely clear about the integrity of this rulemaking process – the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not sign-off on a final Basel II framework until we have fully considered all comments received during our notice and comment process – as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made.

The OCC fully supports overhauling the existing capital adequacy framework. The original Capital Accord, groundbreaking when adopted in 1988, has become increasingly obsolete. Moreover, the OCC fully endorses the goals and objectives of Basel II. The Basel Committee's efforts in this regard are to be commended. They have advanced the cause of international cooperation, supervisory competence, effective risk management practices in financial institutions, and the safety and soundness of the global financial system.

Having said that, I should add that significant work remains before the current draft of Basel II can be considered final. Supervisors and bankers, as well as legislators and other interested parties, need to gain a level of comfort that the revised Capital Accord has truly achieved the objectives first enunciated by the Committee in 1999. This minimum level of comfort is conditional on achievement of the revised Capital Accord's objectives from both a theoretical, as well as a practical perspective.

In working towards finalizing Basel II, we must also be mindful of the risks of excessive complexity. Achieving a level playing field among large, international banks has been a principal objective of the Basel Committee since its formation and is a major goal of Basel II. However, the more complex Basel II is, the more difficult it will be to implement it consistently across countries, especially in light of widely varying supervisory structures and approaches. We also need to think carefully about the competitive effects of Basel II on the domestic banking scene. Maintaining an appropriate competitive balance in the U.S. between our large, internationally active banks, on the one hand, and the thousands of smaller banks and thrift institutions, on the other, is a crucial consideration. Finally, we need to avoid issuing a rule that is so prescriptive in its approach that it would discourage innovation in market practices and advances in risk management. I will address each of these challenges below.

Background

The Basel Committee was established in 1974 by the governors of the central banks of the G-10 countries in the aftermath of disturbances in international currency and banking markets, notably the failure of Bankhaus Herstatt in West Germany. Originally, the Basel Committee focused

primarily on cooperation and information sharing among its members. Increasingly, the Committee has come to see its role as promoting international harmonization through the issuance of "best practices" papers and the development of supervisory standards to which its members voluntarily agree to adhere. The Committee does not have any formal authority, and its standards are not legally binding on its members. The Committee's current members are the senior officials of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

One of the most significant efforts of the Basel Committee was the development and issuance of the 1988 Capital Accord (Basel I). Basel I established the framework for the risk-based capital adequacy standards for counter-party credit risk used by all G-10 countries and by most other banking authorities around the world. The first Capital Accord represented an important convergence in the measurement of capital adequacy, a strengthening in the stability of the international banking system, and a removal of a source of competitive inequality arising from differences in national capital requirements.

However, by the late 1990s, the Committee realized that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide large, internationally active banks with a meaningful measure of the risks they face or the capital they should hold against those risks.

In commencing the effort to revise its Capital Accord, the Basel Committee adopted five key objectives to guide its efforts:

- The Accord should continue to promote safety and soundness in the financial system, and should at least maintain the current overall level of capital in the system.
- The Accord should continue to enhance competitive equality.
- The Accord should constitute a more comprehensive approach to addressing risks.

- The Accord should contain approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activities.
- The Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

The development of Basel II has been a prolonged and often difficult process. The first public document, Consultative Paper No. 1 (CP-1), was issued in June 1999. That document provided the framework of Basel II, but provided few details. The Committee provided additional detail on the specifics of Basel II in its January 2001 issuance of Consultative Paper No. 2 (CP-2). Although it was more than 500 pages long, CP-2 still left a number of key issues unaddressed and unresolved. Industry reaction was mixed, with concerns expressed regarding the incompleteness of the proposal, regulatory burden, the treatment of operational risk, and a potential spike in regulatory capital requirements.

Current Basel Proposal

Since the issuance of CP-2, the Basel Committee and its numerous task forces and working groups, have been laboring to complete a series of revisions to Basel I. In addition to assessing the comments received on the first two consultative papers, Committee staff and principals have made numerous contacts with third parties to understand the nature of the comments and to assess more completely the likely effect of Basel II on measured levels of required regulatory capital, risk management systems, data requirements, supervisory programs and credit availability.

An important component of the impact assessment has been the Basel Committee's quantitative impact surveys. The Committee concluded its third Quantitative Impact Study, known as QIS-3, on December 20, 2002. The objective of the three impact studies has been to assess the impact of Basel II on required capital levels across all Basel-member countries. The individual bank regulatory capital amounts submitted under the impact studies provide indications of whether the Committee has met the first key objective for the new Basel Accord – ensuring that the new

framework maintains the current overall level of capital in the system. At this point, Basel Committee staff is still analyzing the results of the QIS-3 exercise.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As described by the Committee in a July 2002 press release, and subsequently reaffirmed, the remaining timeline for adoption of Basel II is as follows:

- May 2003: Issuance of Consultative Paper No. 3. A three-month comment period is expected for this document.
- December 2003: Finalization of Basel II by the Basel Committee.
- December 2006: Implementation of Basel II.

Forthcoming Consultative Paper No. 3

While work on Consultative Paper No. 3 (CP-3) continues, we are in a position to describe much of its expected content. The attachment to this written statement provides a summary of the substantive provisions likely to be contained in CP-3. As before, this iteration of the proposed new Accord will have three mutually reinforcing "pillars" that comprise the framework for assessing bank capital adequacy. The first pillar of the new Accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings-based (IRB) approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy, and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be

seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the Committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the Advanced IRB approach, the new Accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the U.S. Even when adopted by the Basel Committee, the revised Basel Accord will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 U.S.C. 551, *et seq.*, the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to fully comply with these requirements. We believe that the solicitation and assessment of comments is a critical step in determining the workability and effectiveness of Basel II and related domestic capital regulations.

This summer, the U.S. banking agencies expect to issue an Advanced Notice of Proposed Rulemaking (ANPR) soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR, which would be largely based on CP-3, would provide a description of proposed revisions to current capital regulations, seeking comment on outstanding or contentious issues, a draft of qualifying criteria for those banks seeking to make use of the advanced methodologies set forth in Basel II (i.e., the Advanced IRB approach for credit risk and the Advanced Measurement Approaches (AMA) for operational risk), and supervisory guidance articulating general supervisory expectations.

Recognizing that CP-3 will likely be as lengthy and complex as its predecessors, we understand the importance of U.S. banks being able to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, this ANPR will provide a meaningful forum for a dialogue on Basel II.

After fully assessing comments generated during the ANPR process, the U.S. banking agencies will develop specific regulatory language for a full Notice of Proposed Rulemaking (NPR). In order to meet the aggressive timeline for the adoption of Basel II, the agencies anticipate issuing the NPR in the fourth quarter of 2003. Again, the banking industry and other interested parties will have a full opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

I want to focus on two important, unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR – the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the U.S. expects to set forth in the ANPR definitive criteria for identifying which banks in the U.S. will be subject to the new Accord. In 1988, despite language in the Capital Accord permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to all U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, proposed regulatory text incorporating Basel II concepts will apply on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the

ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policy, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles and core elements of the revised Basel Accord, the language, structure and degree of detail of U.S. implementing documents could be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory and accounting structures and practices in place in the U.S., including, for example, regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As is described more fully in the attachment, the U.S. agencies will likely propose for notice and comment a Basel II-based regime incorporating the Advanced IRB approach for credit risk, the AMA for operational risk, and the internal ratings approach for market risk.

As noted above, we believe that the solicitation and careful consideration of comments is a critical step in the overall assessment of Basel II and related domestic capital regulations. U.S. banking agencies will work within the Basel Committee to ensure that comments by U.S. banks or other interested persons are appropriately taken into account prior to the finalization of Basel II.

Status of Basel Proposal – Outstanding Issues

Despite the protracted nature of Basel II deliberations, significant issues remain, and the aggressive timeline for implementation of Basel II noted earlier will almost certainly be under pressure.

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its Chairman, William McDonough, President of the Federal Reserve Bank of New York. The OCC strongly supports the objectives of Basel II. These objectives,

restated above, constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort.

While theoretically sound, the concepts underlying Basel II present significant implementation challenges. Those concepts have their foundation in modern financial theory. However, some of the concepts, such as the Advanced IRB approach for credit risk and the AMA for operational risk, are untested, with only limited industry practice to substantiate their practicality. Agency staffs have worked diligently, but have not yet achieved a necessary level of comfort with the effectiveness of many of these Basel concepts in application. Moreover, the agencies have not fully assessed the effect of Basel II on bank regulatory capital, risk management systems, data requirements, supervisory programs and credit availability. For example, there is an obvious tension between the objectives of maintaining the current overall level of capital in the banking system, on the one hand, and, on the other, providing an inducement to banks to lower their capital by investing in more refined risk measurement systems. A discussion of some of the specific unresolved implementation issues is provided below.

Complexity

Perhaps the most important objective for Basel II enumerated by the Basel Committee is that the Accord should promote approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's balance sheet and activities. This desire for risk sensitivity has led to a proposal that focuses on a bank's own determination of risk. Reliance on internal determinations of risk for capital adequacy, however, is a radical departure from Basel I and mandates changes in the way we structure the capital framework. In order for external stakeholders – shareholders, creditors, and supervisors – to have confidence in the capital numbers produced by the proposed system, bank internal risk determinations will have to be verifiable. Much of the material developed as part of the Basel II process seeks to specify expectations for rating systems, control mechanisms, audit processes, data systems and other internal bank processes in an attempt to gain comfort with the reliability of internal determinations of risk by individual banks. The challenge for supervisors, however, is to create a

verifiably accurate system that does not at the same time stifle innovation in risk management and that takes into account practical cost/benefit considerations.

I have consistently expressed profound concern about the level of detail and specificity of the Basel proposal. In my view, the complexity generated in Basel II goes well beyond what is reasonably needed to implement sensible capital regulation. CP-2 reflected a desire to develop encyclopedic standards for banking systems that minimizes the role of judgment or discretion by those applying or overseeing the new rules. While the intent of such prescriptiveness is to promote consistency and uniformity in the application of Basel II, this approach is highly problematic, especially in the rapidly changing financial landscape that confronts both financial institutions and supervisors. It must be recognized that credit risk management is continuing to evolve in the financial services industry. Banks currently use a variety of different approaches to estimating appropriate capital levels and no "best practice" has yet emerged.

A highly detailed capital rule may make it easier to compare banks' capital numbers. But it may not be possible, or even desirable, for the Basel Committee to craft a capital rule that prescribes to the same level of detail a uniform set of risk management systems and processes that each individual bank would be expected to put into place. Our large banks are not homogeneous entities – their operations and business strategies vary significantly. A highly detailed and prescriptive rule that would apply to every large bank may have unintended consequences. And while we do not know the magnitude of the ***cost*** of attempting to implement such a prescriptive rule, we do know that there will be costs. One cost will be the burden on banks of conforming their current systems and processes to what is required under the new rule. A related cost is that we may lock banks into a particular way of measuring risk that may, ultimately, prove to be inferior to, as yet, undiscovered techniques.

We should remember that Pillar 2 and Pillar 3 were introduced precisely because of recognition by the Committee of the limitations of Pillar 1's formulaic approach to determining capital requirements. Pillars 2 and 3 offer complementary sources of discipline over bank risk taking. In short, with more modest expectations concerning the need for precision under Pillar 1 comes more modest demands for prescriptiveness.

While much is still unclear about the issues that will determine the correct balance between prescriptiveness and flexibility in the proposed capital reform, I offer three guiding principles. First, the capital rule that we implement must respect the evolutionary nature of risk management. As regulators we must acknowledge that we are still in the relative early days of credit risk measurement and we must recognize the inevitability of further innovation. We are about to propose a capital rule that will require banks to devote significant resources to developing and implementing complex measurement systems, data systems, and control structures. While we believe that some amount of additional expenditure for those purposes is justifiable on the basis of a new approach to regulatory capital requirements, we recognize that there will be a limit to that justification. And one factor that contributes to that limit is the possibility that banks will want to change those systems and structures in response to improvements in risk measurement technology.

Second, Basel reform should, in our view, be more principles-based than is suggested by the level of detail in the Basel documents. Attempting to regulate a bank's internal capital assessments, a complex and evolving field, by issuing detailed and prescriptive rules will most likely create an environment in which banks are constantly developing new instruments and practices not anticipated by the rules. The concern about the complexity of Basel II is similar to the current debate on possible improvements to the U.S. financial reporting system, especially as it relates to the U.S. accounting standards process. As you know, in the Sarbanes-Oxley Act, Congress required the Securities and Exchange Commission (SEC) to study the adoption of a system of principles-based accounting standards[1]. In recent testimony[2], the Chief Accountant of the SEC described the rules-based versus principles-based accounting standards debate in the following way: "Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting." A principles-based accounting standard "requires financial reporting to reflect the economic

[1] See section 108(d), Sarbanes-Oxley Act, Public Law No. 107-204 (January 23, 2002).
[2] See Written Statement, Robert K. Herdman, Chief Accountant, U.S. Securities and Exchange Commission, Before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives (February 14, 2002).

substance, not the form, of the transaction . . . . Principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues."

Third, regardless of the degree of specificity of the proposal, the document must be written in a manner that is understandable to the institutions that are expected to implement it, and to third parties, without regard to the complexity of the subject matter. It is imperative that the industry and other interested parties understand the proposed regulatory requirements and appreciate the supervisory expectations, if they are to provide a meaningful assessment of the consequences of the proposal. It is also imperative that any final capital rule be understandable by banks and supervisors in order to minimize unnecessary regulatory burden due to misunderstandings and confusion. And finally, given the importance of disclosure under Pillar 3 in reinforcing the efficacy of capital regulation and supervision, it is imperative that outside stakeholders in banks understand the operation of capital requirements.

Competitive Equality

The second stated goal of the Basel Committee in developing Basel II was that "the Accord should continue to enhance competitive equality." Despite QIS-3 and other similar efforts, however, we are not in a position to definitively assess the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. We are particularly concerned that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks; between banks and non-banks; and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field

for international banks is an admirable one, and an appropriate goal of the Committee's efforts. Yet one must question whether the exceedingly complex and highly prescriptive approach to capital reflected in Basel II will truly foster competitive equality.

Global rules, no matter how carefully weighed and measured, are not a satisfactory substitute for judgment, especially in a field like financial risk management, where the state of the art is constantly in flux. In the United States, we have a highly developed – some say intrusive – system of bank supervision. For example, the OCC has full-time teams of resident examiners on site at our largest banks – as many as 20 to 30 examiners at the very largest. In addition, most U.S. institutions are also subject to holding company supervision by the Federal Reserve, and in some cases by the FDIC and state supervisors. In other countries, by contrast, supervision may rely less on bank examiners, as we know them, and more on outside auditors to perform certain oversight functions. Given such disparities in the methods of supervision, I submit that U.S. banks are more likely to be subjected to more vigorous enforcement of a set of complex and prescriptive rules, and less likely to be the beneficiaries of permissive exceptions, than banks in countries whose supervisory practices fall at the other end of the spectrum.

Second, for many banks, the principle source of competition is not other insured depository institutions, but non-banks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II-based concepts in the U.S. will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and non-banks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacerbate the current differences. These concerns have been focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Third, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II-based requirements and small and mid-sized banks subject to the current capital regime. This structure is premised on the belief

that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking institutions. The Basel II framework was developed to address the unique risks of large internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions. See Advance Notice of Proposed Rulemaking, Simplified Capital Framework for Non-Complex Institutions, 65 FR 66193 (November 3, 2000). Industry comments were overwhelming negative on the proposal – most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime. There are two primary concerns in this regard. First, banks using a Basel II-based regime will likely have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with small banks for both assets and liabilities. That concern is discussed in more detail in the "Calibration" section below. Second, banks using a Basel II-based regime will have a lower marginal regulatory capital charge for some types of loan products. As stated by the FDIC in a recent paper[3], under the current capital regime, the regime applicable to most small banks after Basel II, a bank making a $100.00 commercial loan is required to hold $8.00 in capital. For banks using advanced methodologies in a Basel II-based regime, the required capital for that same loan would range from $0.37 to $41.65, depending on the riskiness of the credit exposure[4]. The banking agencies must continue to assess this situation and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the U.S.

[3] See "Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back," FDIC Emerging Issues Paper (January 14, 2003).
[4] Calculations reflect representative lower and upper bounds for capital to be held in support of the $100.00 loan. Lower bound reflects an LGD of 10% (high recovery) with a one-year maturity loan. Upper bound reflects an LGD of 90% and a five-year maturity loan.

Operational Risk

Perhaps the most contentious aspect of the proposed revisions to the Basel Capital Accord has been the introduction of operational risk as a separate and distinct component of minimum regulatory capital. I should say at the outset that the OCC supports the view that there should be an appropriate charge for operational risk. Indeed, our banks already take account of operational risk in their own internal economical capital allocations. Since the issuance of CP-1 in June 1999, there have two competing views on the regulatory treatment of operational risk. Some have argued that operational risk is sufficiently similar to credit risk and market risk to be included in the Pillar 1 charge, while others have maintained that operational risk inheres in the quality of an institution's internal control systems, supporting a Pillar 2 approach in which supervisors focus on a qualitative evaluation of such systems. I have consistently advanced the position before the Basel Committee that any charge for operational risk should be committed to the discretion of bank supervisors, under Pillar 2 of the proposal, rather than being calculated through a formulaic approach under Pillar 1. I regret to say that I have not been able to persuade the Committee as a whole to adopt this approach.

Nonetheless, it should be recognized that Basel's operational risk proposal has changed considerably since CP-1, reflecting some convergence from the on-going debate about whether the subject should be addressed under Pillar 1 or Pillar 2. The current operational risk proposal, especially the option of the AMA, which the OCC helped develop, is a significant improvement over earlier proposals. Recognizing the early stage of development of operational risk as a separate discipline, the AMA is a flexible approach that allows an individual institution to develop a risk management process best suited for its business, control environment and risk culture. The AMA tries to balance this need for flexibility with the establishment of broad standards for the identification, measurement, management, control and mitigation of operational risk to ensure a measure of consistency of application.

Despite recent improvements in the operational risk proposal, the OCC remains receptive to comment on this aspect of Basel II. While credit, market and operational risks can all cause

significant financial losses to financial institutions, those risks are not identical in character and the differences need to be reflected in any regulatory capital regime incorporating an operational risk charge. Unlike credit risk and market risk, which a bank consciously assumes in the expectation of financial return, operational risk is an unwanted byproduct of day-to-day business activities. At the same time, banks can take significant steps to mitigate exposure to operational risk ex ante, rather than relying on capital to absorb losses ex post. As was described in a recent paper[5], the trade-off a bank faces in managing operational risk is not risk versus return, but risk versus the cost of avoidance.

As events in recent times have confirmed, internal control deficiencies, external and internal fraud, system breakdowns and other similar "operational" risks can result in significant financial losses, undesirable earnings volatility and reputation damage for individual institutions. The challenge for banks and bank supervisors is to identify the appropriate response to those risks. Banks have used an assortment of risk management tools in addressing operational risk, including enhanced controls, audit, improved risk measurement, pricing, insurance and capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria and supervisory guidance for operational risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

Calibration

As discussed earlier, the first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings-based systems. The recent QIS-3 exercise was designed, in part, to determine whether this calibration exercise was successful. While, as noted earlier, the Basel Committee has not yet officially received a report on the results

[5] See "Operational Risk Capital: A Problem of Definition," Andrew Kuritzkes, The Journal of Risk Finance (Fall 2002).

of the QIS-3 exercise, issues concerning the overall calibration of regulatory capital amounts can be identified and discussed.

To ensure that it meets its goal of avoiding significant decreases in the aggregate level of required capital in the banking system, the Committee has proposed the use of a minimum floor capital requirement in the revised Accord. Under this approach, there will be a single overall capital floor for the first two years following implementation of the new Accord. This floor will be based on calculations using the rules of the existing Accord. Beginning in the first year following implementation, minimum regulatory capital at an individual bank cannot fall below 90% of the minimum level required under the capital rules, and in the second year, the minimum will be 80% of this level.

Based on preliminary analysis, the minimum floor capital requirements may prove binding on a number of U.S. institutions. The OCC does not believe that a reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. The OCC is not yet in a position to make that determination as it relates to Basel II. Given our current understanding of the data provided by banks that participated in QIS-3, and the uncertainty surrounding those submissions, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

Conclusion

As I have indicated, the OCC strongly supports the objectives of Basel II – a more risk-sensitive and accurate capital regime. However, I believe that significant work remains before the current draft of Basel II can be considered final. This summer, the OCC and the other banking agencies expect to seek notice and comment on an ANPR that translates the current version of Basel II into a regulatory proposal and accompanying supervisory guidance for U.S. banks. Once this process is complete, we will be in a position to have a full and complete consideration of the

proposal from all interested parties. As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on a final Basel II framework until we have fully considered all comments received during our notice and comment process. If we determine through this process that changes to the Basel proposal are necessary, we will press the Basel Committee to make changes, and we preserve our ability to assure that any final U.S. regulation applicable to national banks reflects those views. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

Attachment

Summary of Basel II: The Proposed New Accord
Office of the Comptroller of the Currency

The Basel Committee has been developing the new Accord over the past five years. During that time, two full-scale consultative papers (June 1999 and January 2001) and numerous working papers supporting various elements of the new Accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new Accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the Technical Guidance of the Quantitative Impact Study and the recent consultative paper of Pillar 3 on transparency and disclosure; the underlying documents can be found on the Basel Committee's website at http://www.bis.org/bcbs/index.htm.

The new Accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new Accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the U.S. and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt in to the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to or do not opt to apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new Accord will be definitively resolved only after the U.S. rulemaking process has been completed.

General Structure of the Proposed New Accord

The new Accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new Accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market and operational risk. The new Accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the Accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 Accord, and the new Internal Ratings-Based (IRB) approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new Accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to

support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new Accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new Accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar was subject to a recent redraft and consultation process (ended 2/14/03); the new draft was in response to significant concerns raised about the January 2001 proposal.

Capital for Credit Risk

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex are: the standardized approach, the foundation IRB and the advanced IRB.

<u>Standardized Approach</u>

The 1988 Accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the U.S. today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 Accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50% to 40% and the risk weight on certain retail credits has moved from 100% to 75%. Risk weights for externally-rated corporate credits, currently 100%, will range from 20% to 150%. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development (OECD), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the U.S. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be

appreciably different than that measured under current rules for most U.S. bank, and the marginal changes in capital requirements would not justify the cost of implementation.

Internal Ratings-Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the Committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to developing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of stringent eligibility standards or "qualifying criteria" in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default (PD) estimation processes, frequency and content of risk rating management reports, documentation of risk rating determinations, and evaluation of control functions.
- A one-year PD estimate for each grade must be provided as a minimum input.
- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the U.S. does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the probability of default (PD) of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second

piece is the estimate of loss severity, known as the loss given default (LGD). The final two elements are the amount at risk in the event of default or exposure at default (EAD) and the facility's remaining maturity (M). LGD, EAD and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate, retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposure. The IRB approaches are most developed for portfolios of exposures to corporates, banks and sovereigns.

Another important step is the determination by the bank of the PDs for its loan grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03% (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory defined parameters, while those under the foundation approach would use the framework set forth in the new credit risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD (loss severity) based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function, which provides maximum risk sensitivity and flexibility in accommodating diverse bank risk rating systems. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8%.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new Accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006, will actually have to begin calculating results as of December 2005, while continuing to run its current systems.

Adjustments to the Capital Charge for Credit Risk

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

Credit Risk Mitigation

The new Accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that the credit risk mitigation proposals in the new Accord are generally only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the U.S. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty, but there are no specific proposals for adjusting the capital requirement for transactions that include credit risk mitigation techniques. It is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new Accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance sheet netting arrangements. The Committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility

that may be inherent in the mitigant. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit risk mitigation by expanding the type of collateral, guarantors and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

Asset Securitization

Asset securitization is clearly an important issue in the U.S., as the securitization market is significantly greater than the securitization market of any other Basel member country. The Basel Committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel Accord applies generally when there is a transaction that involves the stratification or tranching of credit risk. The Committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long and short term rating categories. Off-balance sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that have adopted the IRB approach for credit risk are required to use one of two methods for determining capital requirements for securitization exposures. One method is the Supervisory Formula Approach (SFA), under which capital is calculated through the use of five bank-supplied inputs: the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); the tranche's credit enhancement level and thickness; the pool's effective number of loans; and the pool's exposure-weighted average loss given default (LGD). The second method is known as the Ratings Based Approach (RBA). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the Accord and its impact on the industry is not yet fully known. In the latest QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. Due to a number of questions about the proposal, the QIS results did not provide entirely reliable results, and it appears that more work is needed to make the proposal more understandable for banks.

Operational Risk

One of the most significant changes in the new Accord is the proposal for an operational risk charge. It is expected to represent, on average, 10-15% of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The Committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The Basic Indicator Approach (BIA) is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the Committee and multiplying it by an indicator, gross income. The next approach is known as the Standardized Approach and is similar to the BIA, but breaks out gross income into business lines. Because there is no compelling link between these measures and the level of operational risk, the U.S. does not plan to utilize the BIA or the Standardized Approach to determine the capital charge for operational risk.

The Committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the Committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the Committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The Committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The Committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the Advanced Measurement Approaches (AMA). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new Accord include the need for internal and external data, scenario analysis, consideration of business environment and internal control factors, and an adjustment for qualitative factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants are effective.

Temporary Capital Floors

Two floors that have been established for the Basel II framework. In the first year of implementation, the total capital requirement cannot fall below 90% of the result the bank would have had under the current (1988) Accord; in the second year, that floor drops to 80%.

It is a pleasure, Mr. Chairman, to appear before this Subcommittee and present our concerns on the revised Basel Capital Accord. I am Sarah Moore, and I am Executive Vice President and Chief Operations Officer of The Colonial BancGroup, Inc. Colonial BancGroup is the holding company for Colonial Bank, a state-chartered, Federal Reserve member bank. We are headquartered in Montgomery, Alabama, and maintain banking offices in Florida, Alabama, Georgia, Tennessee, Texas and Nevada, with a total of 273 locations. As of year-end 2002, we had approximately $15.8 billion of assets.

We anticipate the impact of the new Accord will be far-reaching, as it will affect not just the largest banks; rather, its effects will be felt by banks of all sizes. Moreover, it will have a measurable effect on the nation's economy as well. We appreciate the Subcommittee's foresight in undertaking to examine the effects of the Accord, and we applaud the Subcommittee for giving this matter the priority it deserves.

The revised Basel Capital Accord is a formidably complex document. We believe Basel II will have the unintended consequence of giving the largest U.S. banks an unwarranted competitive advantage over smaller institutions that compete against them, and, additionally, will place all U.S. banks at a competitive disadvantage to nonbanks and to foreign banks. We further believe that, as drafted, Basel II will lead to loss of credit opportunities in the real estate sector, since the Accord treats lending to this area in an unreasonably disparate manner. It is foreseeable that, as a result, financial institutions will divert their resources away from real estate lending, preferring instead to make loans to those sectors that are not as "capital expensive."

In light of these and other issues created by the revised Accord, we urge the Congress to exercise appropriate oversight of any proposed international capital accord with the members of the supervisory committee of the Bank for International Settlements, and urge that it do so by imposing the requirement that, prior to agency action on any such international agreement on capital standards, the Federal banking agencies (in consultation with the Secretary of the Treasury) thoroughly evaluate the impact of such agreement and submit a joint report to the Committee on Financial Services of the House of Representatives, describing their joint findings and the merits of the proposed agreement.

TREATMENT OF REAL ESTATE

The most problematic issue in the proposed New Basel Capital Accord for Colonial Bank and other regional banks is the proposed treatment of commercial real estate and the resulting impact on our bank, our customers, and the economy. Regional and community banks such as Colonial provide most of the commercial real estate lending in the southern United States. The Accord is intended to provide an incentive for banks, in the form of lower capital requirements, to employ sophisticated loan portfolio modeling techniques, loss migration tracking tools, and risk modeling tools, all of which are part of what the Accord calls the "Internal Ratings Based Approach" to calculating credit risk.

Its proponents have argued that the Accord will reduce the capital requirements for certain banks; however, with respect to real estate lending, not all banks will be able to utilize the tools under the Accord for this purpose. While all other types of lending can utilize the tools

envisioned under the Accord, real estate lending is treated disparately. Commercial real estate lending is identified in the Accord as a more volatile, higher-risk type of lending than every other type of lending. Banks that use these risk-assessment tools to measure the performance of their real estate portfolios cannot – regardless of the performance of those portfolios – gain entitlement to lowered capital requirements, as the Accord allows them to do in respect to every other type of lending.

In fact, the drafters have chosen to set risk weights on these assets, without room for adjustment, at substantially higher levels than on loans to other sectors. As a result of this arbitrary characterization of real estate lending, and despite the millions of dollars that will be spent in developing the models and tools needed to comply with the Accord, banks will not be permitted under the Accord to adjust their capital levels to reflect the actual risk level posed by real estate lending as determined by the tools themselves. This treatment discourages participation by banks in the real estate sector, since such lending will carry an unreasonably higher capital expense when compared to a bank's other lending opportunities.

"Asset correlation" is cited as the primary reason that commercial real estate loans are carved out from all other types of loans and are assigned a higher risk rating. The drafters of the Accord state that commercial real estate loans have a tendency to default in "clumps," and that it therefore is more likely that a large group of individual loans would default together and produce a large portfolio loss. We submit that it may just as easily be posited that many other types of loans exhibit similarly high levels of asset correlation, as we have seen recently in the

technology, telecommunications, and airline industries, to name a few; yet loans to those industries are not singled out for higher risk weightings.

At the end of the day, regardless of the type of lending, the best measure of how soundly banks lend money is to review net charge-off ratios over time. Why didn't the Basel Committee use net charge-off data for all U.S. banks to develop risk-based capital allocations? I'll tell you. The numbers do not support the capital treatment provided under the new Accord. This is made quite clear in the graph that we have submitted as a part of this testimony.

This graph illustrates net charge-offs by loan type for all commercial banks, from 1985 through the 3rd quarter of 2002. You can see from the data that since 1995, commercial real estate loans have experienced lower net charge-offs than consumer loans and commercial loans, yet, under the Accord, banks must carry higher levels of capital for commercial real estate loans than for those types of loans.

Much of the bias against commercial real estate lending is based on the losses in commercial real estate that were incurred during the 1980's. Since then, much has changed. New laws and regulations, improved bank underwriting standards such as minimum debt-coverage ratios, cash-flow analyses, independent appraisals, proactive management of nonperforming assets, and increased sophistication in market information, have worked in concert to improve banks' commercial real estate lending. The net result has been low net charge-offs in commercial real estate over the past ten years. Again, I would refer you to the graph submitted with this testimony.

In an interesting twist in the Accord, we have found that if a borrower has a good credit rating, it will be less burdensome for a bank to make unsecured loans to that borrower, than to make loans collateralized by real estate to that same borrower. Under Basel II, a bank that makes an unsecured loan to a corporate borrower with a Moody's "A" credit rating will be required to maintain less capital than it will for a loan in the same amount, to the same corporate borrower, that is secured by commercial real estate.

Let's walk through an example of how a commercial real estate loan is treated under the New Accord, versus an unsecured loan to WorldCom. Assume we have a $100,000 loan collateralized by a fully leased office building. Let's assume also that the borrower has good repayment history and that the loan is performing as agreed. The rating assigned to the loan is satisfactory. This loan will carry a capital charge of $8,000. By contrast, a $100,000 unsecured loan to WorldCom, which had a Moody's credit rating of "A2" prior to the company's announcement of accounting irregularities, would have carried a capital charge of only $1,600. Which one do you perceive as higher-risk: a loan collateralized by real estate that you can touch and resell, or a promise to pay from a telecommunications company? The disparity in capital requirements under the most basic approach in the new Accord is startling . . . the disparity increases dramatically as you move along the risk-management continuum.

While the Accord is intended to strengthen banks, in this instance it encourages making unsecured loans rather than secured loans. Encouraging banks to choose unsecured lending over secured lending is certainly not the way to add strength to a banking system. What will this

mean to our bank, our customers, and the overall economy? As a result of the higher capital requirements, there may be less credit available for the industry, and it will be provided at a higher price. Our fear and your fear should be that lack of credit availability, combined with the increased prices necessarily charged to commercial real estate borrowers, could reduce growth, opportunities, and employment in the economy.

COMPETITIVE DISADVANTAGES UNDER THE REVISED ACCORD

Although there have been public statements by regulators that Basel II will apply only to the twenty largest banks in the U.S., in reality regional banks are being told to prepare to put into place the advanced methodologies set forth in the Accord. Even if the Accord were to apply only to the largest banks, it would not mean that smaller institutions will not feel its effects. Under Basel II, there are two methods by which a bank may calculate its risk weights. These approaches are the Internal Ratings Based Approach, and the Standardized Approach.

Under the more sophisticated Internal Ratings Based Approach, a bank will be allowed to determine its risk weight (and, therefore, its capital requirement) for each asset, e.g., a loan, based on its own internal data. Approval to use this approach is not obtained easily or inexpensively, however, because banks seeking to use the Internal Ratings Based Approach are required to dedicate a significant amount of resources, both human and economic, in order to deploy the systems required for its use. Banks that cannot or will not make this substantial investment will be required to use the Standardized Approach.

Under this method, a bank's regulators will largely determine what its capital requirements are by assigning a range of possible asset risk weights for the bank to apply, based on the types of loans and assets that the institution holds. This approach is similar to the method utilized under the current Accord. Unfortunately, the existence of this dual system puts small and medium-sized banks at a competitive disadvantage to their larger brethren, namely, those banks in the top twenty.

For example, there will be times that a larger bank, utilizing the advanced approach, will have a lesser capital requirement for a particular loan than would a bank of smaller size that utilizes either the Standardized Approach or follows current guidelines. As a result, the larger bank, because of the less stringent capital requirement to which it is subject, will be able to charge a lower interest rate, on the exact same loan, than a smaller bank can charge. Thus, the Accord automatically provides the larger bank with a distinct competitive advantage in loan pricing.

A further result is that the larger bank, not being limited by the increased capital requirement imposed on the smaller bank, also is able to support a greater volume of earning assets with the same amount of capital, thereby placing smaller competitors at an even greater disadvantage. The result is that the larger bank can achieve higher returns on its capital than the smaller competing institution.

Obviously, these inequalities could be eliminated if all institutions could use the more sophisticated Internal Ratings Based Approach. Indeed, our regulators have informed us that we

may voluntarily follow the revised Accord's processes and thus implement this system. However, the numerous requirements that must be met in order to satisfy the criteria for utilizing the Internal Ratings Based Approach mean that any potential benefits thereunder would be eroded by the cost to our bank of acquiring the necessary systems, software, and personnel that the Approach mandates.

As it stands today, only the largest institutions have the resources that would enable them to employ, on a cost-effective basis, the extensive measures required by the Internal Ratings Based Approach.

The proposed Accord also would create an uneven playing field as a result of the lending patterns of the largest banks in the country, compared to those of regional and community banks. At all holding companies having assets over $200 billion, as of September 30, 2002, commercial real estate loans, as a percent of total loans, was only 5.3 percent. On the other hand, at all holding companies under $15 billion, on the same date, the percentage of commercial real estate loans was 10.7 percent. Thus, the Accord's automatically harsh treatment of commercial real estate lending disadvantages smaller institutions far more than larger institutions.

This disparate impact is particularly pronounced when one reviews the relevant data for individual banks in this regard. Below are the percentages for the listed institutions as of September 30, 2002:

Bank:		Commercial Real Estate Portfolio Percentage:
Citibank	--	1.0%
J.P. Morgan Chase	--	1.6%
North Fork	--	19.79%
Wachovia	--	13.6%
Colonial	--	27.1%
Regions	--	20.1%
SouthTrust	--	24.7%
Cullen Frost	--	20.99%
Zions	--	28.7%

MARKET CAPITALIZATION

Another consequence of the dual system for calculating risk weights that causes us concern is the potential for negative market perception toward banks that do not adopt the more sophisticated approaches set forth in Basel II. Any perceived lack of sophistication in bank management could lead to a sell-off of an institution's shares. Thus, even if the Accord may apply only to the top twenty banks, smaller institutions wishing to avoid any such perception may feel market pressure to voluntarily adopt Basel II's provisions. If, as a result of insufficient resources, they cannot do so, they likely will see their market capitalization decline, based on a perceived lack of sophistication. Thus, the very supervisory tool that is meant to bolster bank capital may in fact have the directly opposite result.

ENFORCEMENT ISSUES

Finally, as an internationally active bank we believe there is one further issue that we must call to your attention. An undesirable circumstance encountered by the original Accord, which continues to this day, is the inconsistent manner in which, first, different countries define "capital" under their accounting systems, and, second, their regulators enforce the capital requirements of Basel I.

By effectively broadening the scope of what constitutes capital, certain countries have allowed their banks to claim adherence to the standards imposed by the original Accord, while, in truth, their capital levels are quite thin. For example, as we speak, Japanese banks are allowed to count as capital certain tax-deferred assets. According to Japan's tax-deferred accounting rules, banks can count as capital taxes that were overpaid but that will be returned in the future in the form of tax breaks.

As *The Wall Street Journal* reported on October 30 of last year, "The [Japanese] regulations allow bank capital to be crammed with squishy stuff like potential tax credits and securities the banks will have to redeem in the future . . . as harder types of capital, such as shareholders' equity, are eroded by losses on bad loans and declining stock prices." Despite reports that many of Japan's largest banks are under water, their capital ratios are still touted as being in compliance with the requirements of the original Accord. As a result, the risk-taking activities of these banks are not adequately measured by the Accord, and thus they are not held to

the same standards as U.S. banks. International competition is skewed in their favor because of Japan's lax enforcement of the Accord.

As with enforcement of the original Accord, we fear that the revised Accord will be enforced by some countries in a similarly haphazard manner. Because of such inconsistent enforcement, we fear the goal of attaining a true international banking standard, with equal competitive footing, will not be achieved.

CONCLUSION

Let me conclude by saying that the United States banking system is unlike any other in the world. Our system, ranging from small community banks, to regional banks, to large multinational banks, is without parallel in the global community. Moreover, the fact that all of these institutions, of various sizes, can compete equally in the same U.S. marketplace is a testament to our nation's system of free enterprise. Unfortunately, it appears the drafters of the revised Accord have not taken such a unique banking system into account.

As a result of the inherent flaws in the Accord, if it is allowed to remain in its present form, it will benefit only a handful of the largest U.S. banks, while the majority of community and regional banks will be burdened by higher capital requirements and increased expenses. Moreover, the disparate treatment of commercial real estate lending will manifest itself through significant credit crunches and dismal economic performance.

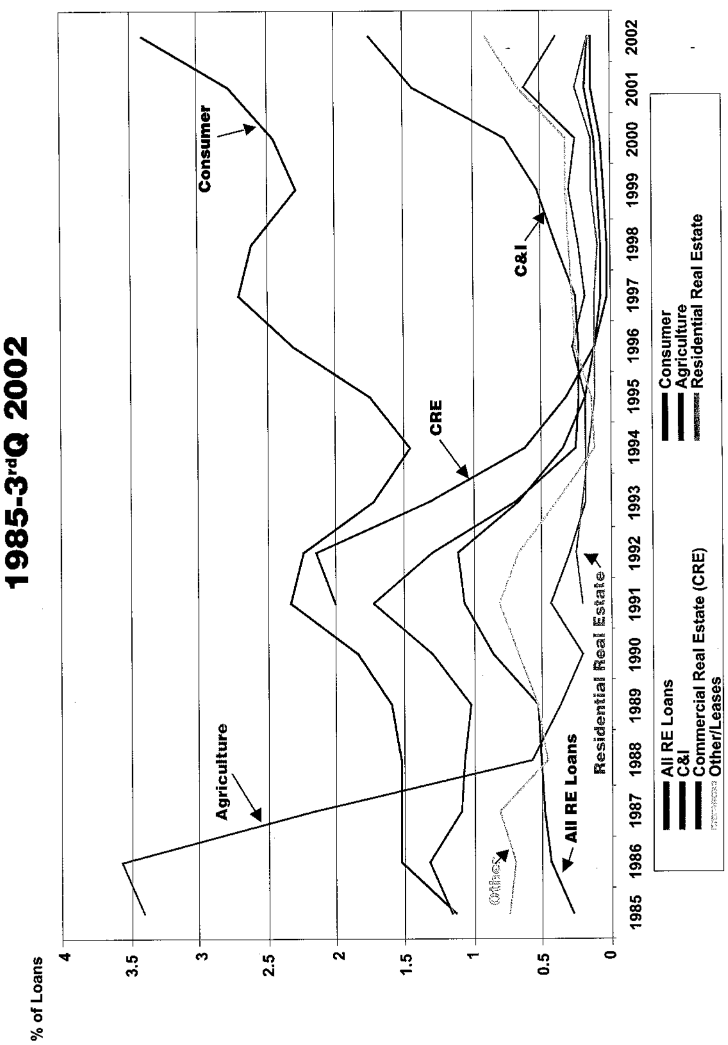
With that in mind, we urge the Congress to require that, prior to agency action on any international agreement on capital standards with members of the supervisory committee of the Bank for International Settlements, the Federal banking agencies (in consultation with the Secretary of Treasury) evaluate the impact of any such proposed agreement, taking into account the following factors:

1. The cost and complexity of the proposal;
2. The impact of the proposal on small and medium-sized financial institutions;
3. The impact of the proposal on real estate markets;
4. The merits of an operational risk standard;
5. The impact of the proposal on competition between banks and nonbanks;
6. The need for additional training for supervision and examination personnel; and
7. Any comments submitted by the public after a notice and comment period of not less than 60 days.

We further urge that the Congress require the agencies (in consultation with the Secretary of Treasury), upon their completion of such evaluation, to submit a joint report to the Committee on Financial Services of the House of Representatives, addressing the foregoing factors and describing their joint findings on the merits of the proposed international capital agreement.

I thank the Subcommittee once again for the opportunity to be heard today, and for allowing me to express the views and concerns of my colleagues on the revised Basel Capital Accord.

Annual Net Charge-off Rates
1985-3rdQ 2002



Source: Charge-off Rates, All Banks, Not Seasonally Adjusted from Federal Reserve Web site: www.federalreserve.gov

TESTIMONY

BASEL II:

Policy Issues in Complex Proposal Warrant Congressional Scrutiny

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the
Domestic and International Monetary Policy, Trade and Technology Subcommittee
Committee on Financial Services
U.S. House of Representatives

February 27, 2003

It is an honor to appear today before this Subcommittee to discuss the potential ramifications of the international risk-based capital rules under consideration in Basel for U.S. financial institutions and – even more important – for the economy that depends upon them. I am managing partner of Federal Financial Analytics, a consulting firm that advises a range of financial services firms on U.S. legislative, regulatory and policy issues affecting their strategic planning. In this capacity, we advise a variety of companies on the implications of specific sections of the Basel proposal. We also advise the Financial Guardian Group, which represents those U.S. banks most concerned with the proposed operational risk-based capital charge.

Today, I would like to highlight:

- the need for a common-sense solution to the problems the revised Basel rules aim to fix. This means quick action on agreed-upon flaws that increase risk, and conservative and cautious action on the more complex problems where solutions could have unintended and costly consequences;

- the importance of the Basel Accord. Despite its complexity, these rules drive bank profitability in lines of business like mortgage and small-business lending, so they will have a direct impact on credit availability and macroeconomic performance;

- the need to get credit risk-based capital right, regardless of the final capital requirement imposed on individual banks. Now, Basel thinks 8% is the right number. In fact, banks with low-risk portfolios should hold far less capital and those with higher-risk books can and should hold more. Efforts to plug the rule to keep the capital number constant will continue the "regulatory arbitrage" problem Basel negotiators aimed to fix when they first sat down at their table more than five years ago;

- the importance of getting the Basel rules right for U.S. banks, which are subject to strict supervisory penalties – including closure – if capital falls below the "prompt corrective action" targets;

- the critical nature of effective supervision. Despite including a supervisory section ("Pillar 2") in the draft Accord, Basel is increasingly focused on capital numbers and not on improving supervisory standards at home and abroad. International capital standards cannot on their own resolve safety-and-soundness problems, as the experience in Japan makes clear; and

- the unique nature of the U.S. financial services industry and the laws under which it operates, which make wholesale implementation of Basel standards problematic. Of particular concern to U.S. banks is the competitive impact of the proposal, given that the rules will not apply to non-banking firms that are major players in the U.S. financial market, as well as the fact that foreign regulators may implement the standards quite differently and adversely affect

> the U.S. position in global trade in financial services. Resolution of which U.S. banks the rules will apply and what version will be implemented is essential to addressing additional competitiveness concerns, as well as ensuring that regional financial markets remain well served. The potentially very high cost of Basel II exacerbates these concerns. Cautious implementation is also warranted by the fact that the rules could heighten market booms and worsen busts ("procyclicality").

I should like to emphasize that this statement is not in any way opposed to much of what is proposed in the most recent version of Basel II. Indeed, some of it is so good and so important that I think it should be immediately implemented. However, I fear that other aspects of the complex rule could have unintended consequences, and these should be approached cautiously after the keystones of the current proposal are put in place.

The Cost of Complexity

Economists and financial analysts at regulatory agencies around the world have spent literally thousands of hours working to revise the risk-based capital standards that govern internationally-active banks around the world and all insured depositories in the United States. This effort is an important one because flaws in the first set of capital rules (often called Basel I) have led to undue risk-taking and other concerns that warrant immediate attention. Much of the work to build Basel II is very sophisticated, with elaborate computer models of complex financial simulations driving many aspects of the new standards. Financial markets are now complex, so risk-based capital must be as well. However, at the outset of my statement I would like to mention the work of economists far from the Basel deliberations whose simple and clear guideposts should assist both the final Basel deliberations and Congressional review of them.

Herbert Simon, a Nobel Prize winning economist detailed the importance of "maximization" in making hard decisions like those facing the Basel committee. Quite simply, maximization is not letting the best drive out the good. It's making small decisions based on the facts at hand, avoiding "sunk costs" in sweeping decisions that can have profound, unintended consequences. Organization theorists call this concept "incrementalism" or, less grandiosely, "muddling through." Again, the lesson is to do the best you can with what you know and defer efforts to fix everything everywhere in every way – "synoptic" solutions – to limit unintended and adverse effects.

In my opinion, Basel negotiators have become enmeshed with a sweeping, synoptic solution to the known problems in the current rules. In so doing, they have deferred action on the egregious problems in Basel I that in part, led to the Asian collapse in 1998 and, now, to the credit risk problems at large banks in the wake of Enron, WorldCom, *et al.* Similarly, supervisory action on major emerging risks – operational ones, for example – has been deferred. In fact, the solution to these known and relatively easy-to-fix problems has been postponed at least until January 1, 2007.

Another risk with synoptic solutions such as the one Basel now seeks is the problem of finally implementing them. Regulators are already fearful that they will lack both the knowledge and person-power to review the complicated models banks must have to take advantage of the credit risk internal ratings-based and the operational risk advanced measurement approaches. Without these resources and skills, regulators may well slow the ability of banks to take advantage of these sophisticated models and even thwart them by inappropriate restrictions or mistaken sanctions. Real-world supervisory limits add still more force to arguments for a less ambitious rule that first does what regulators know they can do in areas of clear concern and only then moves on to more difficult tasks.

Why Capital Counts

Before moving on to a discussion of specific issues raised by the current Basel draft, I would like to spend some time on why whatever happens at Basel matters so much in each of your districts – and not only to the banks there, but also to those who rely on banks for a safe place to put their money and a constant source of funding for mortgages, businesses and overall economic development. It's all too easy to get caught up by the hundreds – indeed almost a thousand – pages of the Basel draft and lose sight of what the point of this exercise is or – even harder – why it matters outside the arcane circle of model-builders buried deep in the proposal's details.

Quite simply, regulatory capital is a key driver of bank profitability. Banks – like all other companies – measure profitability on return on equity – that is, how much can a shareholder get if he or she invests in Bank A versus Bank B or Automaker Y or all the other places money can go. For unregulated firms, capital required to bear risk is determined by what the market demands. Banks of course must look to market demands for capital – so-called "economic capital" – but regulators also set capital based on their view of the risk of an asset (e.g., a loan). When economic and regulatory capital numbers differ, regulators win and the bank must hold whatever amount of risk-based capital the regulator dictates to remain in business.

Differences between economic and regulatory capital are among the most important strategic drivers of bank decision-making. When regulatory capital is lower than economic capital, an incentive for the bank to take risk is created because the bank can effectively hold that risk at higher profit than firms subject to the market's demands. This is among the reasons why banks have gone into subprime lending in such a big way in recent years. The crude nature of the Basel I capital requirements imposes a maximum 8% risk-based capital (RBC) charge on assets ranging from short-term bonds offered by AAA-rated companies to portfolios of loans made to people who have gone bust a time or two. The regulatory capital numbers make it unprofitable for the bank to hold low-risk assets (driving them out into the broader market that now dominates in this area), while at the same time making it more profitable – even on a risk-adjusted basis – to take on more speculative assets.

Regulators call this "regulatory arbitrage" – meaning that bankers have figured out how - to maximize profit by exploiting the inadequacies in the current capital standards. Quite simply, the capital rules have a perverse incentive: they encourage banks to hold high-risk assets and sell low-risk ones into capital markets. Basel II began in large part to curb this regulatory arbitrage, and this remains a driving reason for quick action on many aspects of the proposed rules.

Remaining Risk of Regulatory Arbitrage

As noted, Basel II is primarily an effort to eliminate the undue risk-taking that resulted from the crude assignment of RBC in Basel I. However, as regulators seek the synoptic complete new rewrite of risk-based capital, they at the same time appear fearful of the result, which can and should be a drop – perhaps a big one – for banks with low-risk positions. As a result, regulators are attempting to hedge their bets in the complete rewrite of RBC by limiting the ability of banks to take advantage of the massive rewrite once it is finally in place. This strategy means not only that immediate improvements in Basel are unduly put off, as discussed above, but also that the underlying problem in Basel I will remain even after Basel II goes live.

Several of the concessions regulators have made as they try to get a comprehensive new capital rule are particularly problematic from an arbitrage point of view. Of course, all negotiations require compromise, but one as far-reaching as the Basel Accord can result in trade-offs with unintended and undesired consequences. Again, had Basel II focused immediately on the problems in Basel I on which virtually everyone is agreed, these potentially serious adverse consequences would have been avoided. In this regard, I would draw particular attention to the treatment of small- and medium-sized enterprises (SMEs), the proposed operational risk-based capital (ORBC) requirement, and ongoing problems deciding how to recognize credit risk mitigation (CRM).

Before going into detail on these, however, I would like to note that the arbitrage problem is also compounded by the reluctance of regulators – especially those in the European Union – to let banks take full advantage of potential reductions from the changed credit risk rules. The current draft permits banks to drop capital only 10% below current standards in the first year (2007) Basel II is in place and then only 20% below current capital rules in the second year and, perhaps, for an uncertain period thereafter. However, banks subject to an increase in capital will have to boost capital on January 1, 2007, putting all of the cost – but little of the anticipated Basel benefits – on the back of the industry even as it wrestles with the complexity and cost of the revisions.

Specific Arbitrage Problems

Let me talk briefly about specific sections of the Basel II proposal that highlight the arbitrage problem and point to the need for quick action on a smaller-scale rewrite of the international RBC standards.

Treatment of Small- and Medium-Sized Enterprises

I would like to note first the low capital requirements for SMEs in the current draft. Of course, small business is a deserving and very important segment of the economy. I know; I run one. However, SMEs as defined in Basel are firms with annual revenues of up to $50 million – far larger than the ventures we normally consider small businesses in the U.S. Under Basel II, SMEs would be treated either the same as loans to individuals (i.e., retail credit) if the business is small or at terms far more favorable than larger companies in the overall treatment of commercial credit.

However, SMEs are generally far riskier than big companies. Many are start-ups, with all the risks attendant thereto, and most are not tracked by external ratings agencies or others providing banks with an objective credit risk assessment. They also often are not of a size to warrant full-scope credit risk monitoring, so that problems at small companies can go unnoticed by their banks until bankruptcy looms. Assigning the SME charge too low, as Basel has done, creates a regulatory incentive for banks to divert funds into SMEs, based on the fact that banks can arbitrage this low regulatory capital against other lenders who must set aside appropriate economic capital. This may sound like a good idea, especially in the U.S. where we like small businesses. However, we here have a range of tax incentives and even a Small Business Administration designed to ensure an ongoing supply of funds to risky small businesses without creating a threat to the deposit insurance system.

Why this favorable SME capital treatment? Simple – German Chancellor Schroeder last year threatened to take Germany out of the Basel negotiations – stopping them cold – unless U.S. and U.K. negotiators bowed to this capital charge. Germany lacks U.S.-style government agencies supporting small business, and the medium-sized ones are particularly critical to that nation's economy (and, apparently, its hard-fought election last year).

2. Operational Risk

Even as U.S. negotiators were conceding to Germany on the SME question, they last year also made big concessions to Germany and other EU nations on the operational risk-based capital front. This testimony will not go into depth on ORBC, as another witness will do so. However, it is critical to note the potential regulatory arbitrage that may result from the proposed ORBC charge. Each of the proposed approaches to ORBC – including the advanced measurement one – will result in regulatory capital considerably higher than economic capital due to the reliance on gross income, the failure to scale the capital charge and the lack of recognition of proven forms of operational risk mitigation. As a

result, the ORBC charge will induce undue risk-taking – banks will comply with the regulatory capital charge instead of undertaking costly risk mitigation – putting the financial system at undue risk.

3. Credit Risk Mitigation

One of the major arbitrage problems in Basel I at which Basel II is aimed is the current failure of the capital rules to recognize credit risk mitigation – loan insurance, collateral and similar proven ways others stand between lenders and loss. Regulators are hesitant to recognize CRM fully because not all forms of it work all the time. However, some types of CRM have a proven history of absorbing large amounts of credit risk without disputes or counterparty failures. Quick action to recognize these forms of CRM will create an appropriate incentive for CRM – an incentive regulators should clearly make a top priority due to the relative simplicity of doing so.

Mistakes in Basel Can Have a Big Impact on U.S. Banks

Getting RBC right is particularly important in the United States, where federal law and implementing rules mandate a range of serious sanctions when regulatory capital falls. These sanctions were mandated by Congress in 1991 after the S&L debacle of the 1980s and serious problems in the commercial banking sector emptied the federal deposit insurance coffers and cost taxpayers at least $250 billion. The FDIC Improvement Act of 1991 introduced "prompt corrective action" (PCA), under which sanctions are imposed as an insured depository falls below the "adequately-capitalized" level. If capital falls to the "critical" level, bank regulators must either close an insured depository or take other action to ensure prompt recovery.

The 1991 sanctions were increased in 1999 when Congress passed the Gramm-Leach-Bliley Act (GLBA). That statute permits only "well-capitalized" and "well-managed" firms to be financial holding companies, which are in turn the only entities allowed to engage in both banking and other, less traditional financial services. Under GLBA, a financial holding company that fails these standards is subject to immediate and harsh sanctions, including possible divestiture of non-banking activities.

Basel has long advocated adoption of the PCA framework by bank regulators outside the U.S., but progress to do this has been slow. Indeed, virtually nothing happens in most nations when a bank fails the Basel rules, even if the Basel rules have been extensively modified to be as lenient as possible – the case in Japan, for example.

The PCA framework – especially as buttressed by the GLBA sanctions – makes capital count in the U.S. This is appropriate, but it makes it even more important that U.S. regulators ensure that the Basel rules are tailored for appropriate application in the U.S. to avoid both undue competitive implications and unnecessary enforcement actions or even closings that cost the FDIC. Unless or until the PCA sanctions are adopted and enforced

in key financial services markets, U.S. regulators should not concede points in international negotiations that put U.S. banks at unique risk.

Effective, Enforced Bank Supervision Limits Arbitrage

Much in the U.S. supervisory structure noted above – especially PCA – warrants adoption by other regulators, and Basel should devote far more resources than now to improving both the quality of supervision and the enforcement to back it up. The Basel proposal rightly rests on three pillars: Pillar 1 requiring RBC, Pillar 2 mandating improved supervision and Pillar 3 stipulating increased public disclosure to promote market discipline. However, to date virtually all of the regulatory effort has gone into the Pillar 1 capital charge, in part due to the hard work necessary to craft the complex, comprehensive rule on which Basel has, I think, unwisely embarked. Pillar 2 remains in many respects a work in progress, with much of its text replete with platitudes about best practices. However, recent experience in the U.S., EU and Japan points to the critical importance of effective supervision backed up by meaningful enforcement, as well as to the relative irrelevance of international risk-based capital standards when domestic regulators choose to fudge the capital books.

A quick look at just two disputed areas in Basel II points to the critical importance of effective supervision, and the problems an excessive focus on capital can cause. One of the hottest disputes now as Basel tries to finalize the Accord is the treatment of commercial real estate (CRE). Some regulators are proposing a stiff capital charge for CRE, based on the correct perception that CRE is often a high-risk segment of a bank's loan book. Indeed, CRE played a major role in the failure of several large banks, including those in New England, during the late 1980s. However, in response to those failures, Congress required regulators to institute strict real estate lending standards that include such features as tough loan-to-value limits. These have led banks to institute prudent lending practices in this otherwise high-risk sector that have substantially limited their exposure even during this time of regional economic turmoil. A high CRE capital standard might have deterred lending essential to economic development without providing the appropriate discipline of effective supervisory standards. Clearly, in CRE – as in so many other credit-risk sectors, the balance between Pillar 1 and Pillar 2 will be essential in ensuring that Basel gets it right.

Operational risk is another area where inappropriate capital can create serious problems. The September 11 attack pointed to the indispensable importance of operational risk mitigation – disaster preparedness, contingency planning, reserves and insurance. ORBC would have had no impact on the heroic recovery after the terrorist attack, which depended on all these proven operational risk mitigants. In fact, the GAO report on critical financial infrastructure presented to the Financial Services Committee on February 12, 2003 noted that the SEC dropped its capital requirements briefly after the attack and all of the bank regulators noted that failure to comply with them would not have regulatory consequences. A focus on regulatory capital – not recovery – was clearly inappropriate.

Since the attack, regulators have struggled to issue supervisory standards on operational risk, distracted in part by the massive effort to finalize the ORBC charge. Indeed, Basel now plans not to issue final operational risk supervisory standards until year-end, deferring their effective date until the rest of Basel's rules in 2007. This delay points to the problems of pushing for a synoptic rule that tries to solve everything instead of focusing scarce regulatory resources on the most immediate, agreed-upon concerns.

Key U.S. Concerns

Above, I have noted several major concerns with the current Basel approach, including:

- the risks of unintended consequences from an over-comprehensive effort to craft global capital rules;
- the remaining risk of regulatory arbitrage, especially in areas where U.S. regulators have acceded to EU demands; and
- the critical importance of ensuring effective and enforceable supervisory standards. These exist in the U.S., making it still more important to get regulatory capital properly aligned with economic capital as determined by the market.

The complexity, arbitrage and supervisory issues raise problems for all banks covered by the Basel II rules, but they are particularly problematic for U.S. banks in several key respects. These problems may be exacerbated if U.S. regulators proceed with plans under consideration to permit only the nation's top ten banks or so to use the advanced internal ratings-based approach to credit risk under consideration at Basel.

1. Competitiveness

U.S. regulators should take care as they craft Basel II standards that the rules do not adversely affect large U.S. banks in relation to the non-banks that are key financial services competitors in this country, as well as that the rules do not adversely affect U.S. banks vis-à-vis foreign ones in those sectors in which U.S. banks now hold a global edge.

In sharp contrast to the EU, many major financial services firms in the U.S. are non-banks. Almost none of these have chosen to become financial holding companies since Congress enacted GLBA in 1999, largely due to the fact that these firms find the current bank capital rules too removed from the economic ones on which their business strategies are based. To the degree that Basel II standards impose different regulatory capital standards than economic ones, creating the regulatory arbitrage problem noted above, non-banks will remain outside the bank capital system and banks in it will operate at significant capital disadvantages, especially in sectors like asset management and payments-processing where non-banks are major competitors.

In the U.S., specialized banks can operate outside the banking charter, and some may choose to do so if the regulatory capital standards remain at odds with economic ones. This could drive key players outside the valuable supervisory framework that now protects banks and the financial system more generally.

Non-economic capital charges in key sectors also pose global competitiveness concerns. The operational risk-based capital proposal is a particular problem here, due to the major global market-share U.S. banks have in specialized businesses that will be especially hard-hit by the Basel II proposal. However, proposed standards in asset securitization could also be very costly to U.S. institutions that now lead the world in this sophisticated segment of the financial market.

2. Treatment of Smaller Banks

In 1988, U.S. regulators decided that all banks – regardless of size – should be covered by Basel I to ensure competitive equity and introduce the risk-based scheme to all banks. However, the complexity of Basel II is leading regulators to exempt from it all but the nation's very largest banks. This could have profound competitive consequences for banks left outside the Basel II framework unless so many restrictions are placed on it – the above-noted limit on deriving value from the advanced approaches, for example – that the intent of the entire Accord is deeply undermined and the value of the nearly decade-long negotiations is overturned.

As noted, the primary goal of Basel II is to end regulatory arbitrage by getting regulatory capital aligned with economic capital. This means that, assuming Basel II is fully implemented, banks with low-risk books of business will have lower RBC than is now the case. In certain lines of business – mortgages and other loans to average consumers, for example – the Basel II advanced capital numbers are far lower than those now in place. If implemented only for the largest banks, this would mean that some banks – often dominant competitors in selected markets – would have far lower regulatory capital than others in the same sector left subject to current RBC rules.

As noted, capital is a key driver of competitiveness, affecting as it does return-on-equity and other major components of overall profitability. Thus, banks not able to take advantage of the lower Basel II capital requirements will be at a profound competitive disadvantage to those banks able to reduce RBC for credit risk. This could hasten industry consolidation, leading to more product standardization and less focus on regional markets or individual customers. As numerous FDIC and other studies have shown, consolidation also concentrates increasing resources in just a few institutions, heightening potential systemic risk and damage to the deposit insurance funds.

Some U.S. regulators have suggested that this competitiveness concern is not a serious one because large and small banks don't compete. This is manifestly not the case in both major lines of business and regional banking markets all across the country. For example, exempting smaller institutions from Basel II would leave out one of the nation's largest mortgage lenders, which operates through a savings association charter. It could,

regulators argue, volunteer for Basel II to address this competitive imbalance, but its regulator — to date largely out of the overall Basel implementation process — could be unable to allow it to use Basel II or could otherwise limit its value. Similarly, it is hard to see how banks smaller than the top ten but still major competitors in their areas will be content to let the biggest banks under-cut their pricing on mortgages, small-business loans, credit-cards and many other key profit centers.

Again, a more simple approach that fixes key problems in the current capital rules would address this concern, since all but the smallest banks can and should be able to adapt their internal models to a more incremental change in RBC that reduces regulatory arbitrage without all the complexities in the current advanced sections of the proposal.

3. Cost

Both the competitiveness and small-bank issues noted above are compounded by the cost of implementing the complex rules Basel is considering in the fashion now planned by some U.S. regulators. Estimates of course vary, but a forthcoming study reportedly will suggest that Basel II systems development and implementation costs will run about $150 million in large banks and about $10 million in smaller ones (presuming the smaller ones are allowed to use simpler versions of Basel II).

There are no public studies of the cost of implementation to U.S. regulatory agencies, although the extent of the new rules and the qualifications for use of the advanced sections of them suggest these costs could be quite high. Increases in the assessments charged by the Comptroller of the Currency to absorb these costs could affect the cost of doing business for small national banks even if they are excluded from Basel II, while also compounding the potential cost differences for institutions with national charters that pay assessments and those regulated by the FDIC or Federal Reserve, where examination costs are borne without assessments on supervised banks.

4. Macroeconomic Impact

Other witnesses today will discuss procyclicality – that is, the concern that adjusting capital to risk will encourage lots of lending when risks are deemed low (during economic booms) and sharp curtailment in credit availability when times get tougher (busts). This is indeed a major concern in Basel II, one which regulators have sought to allay by augmenting Pillar 1 capital charges by additional "stress test" capital charges under Pillar 2. However, stress-test capital could increase potential arbitrage concerns, muting as it does the value of setting regulatory capital to economic capital in Pillar 1. Further, the comprehensive nature of the Basel II effort may exacerbate procyclicality if any of the many regulatory capital assignments proves faulty and regulatory capital incentives unduly encourage banks to make loans that then prove even riskier during economic downturns.

However, procyclicality will remain a concern even in a revised, simpler Basel II Accord. The more regulatory capital is accurately tied to risk, the greater the regulatory incentive

for low risk-taking. Pure reliance on capital – whether in Pillar 1 or through stress tests – can only allay this fear by undermining the anti-arbitrage goal at which the overall Basel rewrite is aimed. As a result, effective supervision that ensures banks do not concentrate their assets into those that appear low-risk during boom periods is an essential component of a final Basel II.

STATEMENT OF

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CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on the

NEW BASEL ACCORD

before the

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE, AND TECHNOLOGY

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

10:00 AM
February 27, 2003
Room 2129, Rayburn House Office Building

Thank you, Mr. Chairman and members of the Subcommittee. I welcome the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the development of revised international capital standards. In addition, I would like to express my appreciation to the members of the Basel Committee on Banking Supervision and their staff for their dedication and hard work over the past five years in formulating the Basel II Accord. I came into this process eighteen months ago and recognize that much of the ground work had been done before I became involved.

This agreement could have far-reaching effects on the management and supervision of the largest, most complex banking organizations in the world. It is imperative, therefore, the end result of this Accord is better regulation. It is essential that our process be thorough and inclusive; that our deliberations and documentation be transparent; and that the impact of our actions -- to the greatest extent possible – be widely understood by Congress, the regulators, and America's financial institutions.

Bank capital is subject to federal regulation because of its critical importance to the health and well-being of the U.S. financial system. Debt financing creates liabilities banks must satisfy regardless of the severity of external economic events, but capital—essentially the funds contributed by shareholders—can absorb losses without causing a bank to fail. An adequate capital cushion enhances banks' financial flexibility and their ability to weather periods of adversity. The FDIC, as insurer, has a vital stake in the adequacy of bank capital.

The conceptual changes being considered in Basel II are far-reaching. First, the new Accord contemplates a two-tiered regulatory capital standard for America's financial

institutions: one set of rules for the large, complex and internationally active institutions, and another set for the rest of the banks in the country. Second, the Accord represents a significant shift in supervisory philosophy. Rather than emphasizing pre-set minimum numerical capital standards established by the regulators, the new Accord envisions banks using their own internal risk estimates as inputs to regulator-supplied formulas with the supervisors providing oversight and evaluation of the banks' ability to measure risk. Third, minimum capital requirements for credit risk would generally be reduced, with additional capital held based on more flexible elements of the Accord, such as an operational risk charge or the imposition of discretionary supervisory capital buffers.

These are all important issues worthy of the attention of this Committee, the regulators and the financial services industry at large. Each of these fundamental developments raises questions, however, that must be addressed before this new capital structure can be considered a success. There are good arguments for moving forward and the FDIC will continue to support the Basel II process. However, it is important that certain fundamental issues be resolved satisfactorily in the coming months in order for the FDIC to give its full support to the new Accord.

I will focus my testimony on the weaknesses of the capital framework that the largest banks are operating under today and the logic behind the new capital Accord. I will then address the threshold issues that must be resolved prior to a decision by the U.S. to adopt this new Accord, and conclude with a brief discussion of several issues involved that may arise during the implementation phase.

Weaknesses of the Current System

Under the 1988 Capital Accord[1] as implemented in the U.S., assets and off-balance sheet contracts are risk-weighted based on their relative credit risk using four broad categories or buckets. Overall, institutions are required to maintain a minimum risk-based capital ratio of at least eight percent. Most unsecured corporate loans are placed in the 100 percent risk weight bucket, which requires an eight percent risk-based capital charge. Lower risk assets are given lower risk weights. For example, qualifying single family mortgage loans are generally risk-weighted at 50 percent and require only a four percent risk-based capital charge. In addition to the risk-based capital requirements, all U.S. institutions must comply with minimum leverage ratio requirements of Tier 1 capital-to-average total consolidated on-balance sheet assets[2] and all U.S. institutions are subject to the statutorily mandated Prompt Corrective Action (PCA) regulatory capital ratios.[3]

[1]"International Convergence of Capital Measurement," issued in July 1988, describes the framework. The Agencies' risk-based capital standards implementing the 1988 Accord are set forth in 12 CFR part 3 (OCC), 12 CFR parts 208 and 225 (Board), 12 CFR part 325 (FDIC), and 12 CFR part 567 (OTS).

[2]In general terms, Tier 1 capital includes common stockholder's equity, qualifying noncumulative perpetual stock (for bank holding companies it also includes limited amounts of cumulative perpetual preferred stock), and minority interests in the equity accounts of consolidated subsidiaries.

[3]Under the PCA regulations mandated by Congress, institutions are classified into categories based on their regulatory capital ratios. The minimum leverage ratio for strong institutions is 3 percent, and is 4 percent for other banks. As directed by the Federal Deposit Insurance Corporation Improvement Act of 1991, institutions with the highest capital ratios (i.e., at least 10 percent total risk based, at least 6 percent Tier 1 risk based, and at least 5 percent leverage) are categorized as "well-capitalized," while institutions with lower capital ratios are assigned lower capital categories. Institutions that are less than well-capitalized have restrictions or conditions on certain activities and may also be subject to mandatory or discretionary supervisory actions. These PCA requirements are unique to U.S. banks and reflect Congressional intent to reduce the cost of bank failures and reduce opportunities for bank supervisors to practice forbearance towards thinly capitalized institutions.

Since 1988, this system has generally worked well for most small, non-complex banks. However, the activities of the largest banks have reached a degree of complexity not easily addressed under the existing Capital Accord. The business of banking, risk management practices, supervisory approaches and financial markets have undergone significant transformation. The regulators were forced to respond by piecemeal regulatory amendment. Banks were able to take advantage of the rigid "bucket" approach of the 1988 Accord and structure their balance sheets so as to minimize regulatory capital charges. The bucket approach lacks proper sensitivity to risk and is disconnected with internal bank practices. This formula has hobbled the 1988 Accord's ability to match the industry's innovations and has reduced the regulatory capital incentives for better risk-management.

An important argument in favor of a new regulatory capital framework for large banks is that the current system simply ignores most of the best available information about the credit risks faced by these banks, namely, the risk-related information generated by the banks themselves. Large banks generate a wealth of useful information pertinent to evaluating their own credit risks, and finding a way to use this information is an important component of the new capital Accord.

Threshold Issues

The FDIC believes there are three issues that need to be addressed before a commitment is reached to implement Basel II in the U.S. First, the Accord must ensure that appropriate minimum capital requirements are maintained. Second, the new Accord must ensure that the internal risk estimates used as inputs to the new capital formulas are estimated in a sound and conservative fashion and are evaluated consistently going

forward using a uniform interagency process. In addition, the competitive impact of the new Accord must be fully explored and assessed.

As a result of an extensive data collection exercise just recently completed, the regulators have a sense of how Basel II might affect minimum required capital at the largest banks if applied today. The agencies are considering whether and how, in light of these results, the Basel II Accord should be adjusted prior to formal issuance for public comment.

As the process continues, the FDIC's focus will be to ensure that minimum capital requirements under Basel II are not unduly diminished. Substantial reductions in minimum capital requirements for the largest U.S. banks would be a grave concern to the FDIC. Lower capital minimums - in conjunction with a flexible operational risk charge and supervisory discretion to impose additional capital - may work well in theory, but in practice it may be difficult to enforce adequate discretionary capital buffers in cases where a bank itself does not agree that such a buffer is necessary. For the supervisory process – Pillar 2 of the Accord – to be fully effective, it must rest on a foundation of agreed-upon regulatory capital minimums. Congress recognized this when the PCA requirements were established in the Federal Deposit Insurance Corporation Improvement Act. I want to be clear that this is a critical issue for the FDIC.

A noteworthy aspect of the PCA regulation is the minimum leverage capital requirement. To be considered well-capitalized, a bank must have a ratio of Tier 1 capital-to-total assets (the leverage ratio) of at least five percent. Banks with leverage ratios under four percent are considered undercapitalized. There is an exception: "strong" banks (CAMELS "1" that are not experiencing significant growth) are not considered undercapitalized until their leverage ratio falls below three percent. To my

knowledge, this exception has never been used since no bank with a leverage ratio less than four percent has ever met the standards for a "strong" bank.

U.S. banks subject to Basel II will certainly be interested in how the new Accord affects their regulatory compliance with PCA, particularly if their risk-based capital requirement decreases to such an extent that the PCA leverage test becomes the binding regulatory capital constraint. Just as when the PCA regulations were first written, there will probably be arguments that the leverage ratio should not be used as a PCA test because it is not sufficiently risk-focused.

While no one to our knowledge has suggested weakening the PCA leverage regulations, we believe the issue will have to be confronted if Basel II moves forward in its current form. We believe this is one of the discussions that should take place before we commit to adopt Basel II in the U.S.

There are a number of compelling reasons to maintain the leverage ratio as a key capital indicator. The risk weighted assets number that capital is measured against in Basel II is based on bank risk models, which vary according to their assumptions and can – on occasion – be wrong. During economic booms, model inputs are likely to become more optimistic. The estimated base of risk-weighted assets under these conditions could shrink, and the satisfaction of a capital standard of "eight percent of risk weighted assets" could become less and less meaningful.

The measurement of a leverage ratio, in contrast, is much less subject to model error and the creeping effects of economic euphoria. The base against which leverage capital is measured, total assets, is determined outside the bank regulatory process by the application of Generally Accepted Accounting Principles, subjecting the bank regulatory

agencies to a valuable discipline. Moreover, recent legislative and regulatory changes raising the bar on corporate governance standards, enhancing internal controls and disclosure practices, and compelling changes to accounting standards will bring greater scrutiny to the determination of what assets and liabilities are on balance sheet and increase the value of the capital discipline provided by the leverage ratio.

While a leverage ratio provides the institution and the deposit insurance funds with valuable protection, it is certainly not sufficient in itself. Equally important under a Basel II regime is identifying processes that ensure banks' internal risk estimates are estimated soundly and conservatively, and that they are evaluated consistently.

The capital required by the Basel II risk-weight curves is quite sensitive to assumptions about the risk parameters of individual credits. How will examiners evaluate the validity of those assumptions? In this respect, it is important not to place exclusive reliance on quantitative methods and models. Internal risk estimates are likely to be as robust as the credit culture in which they are produced. A rigorous corporate governance structure, effective internal controls and a culture of transparency and disclosure can all play an important role in ensuring the integrity of internal risk estimates. These qualitative elements must be accompanied by agreed-upon processes that examiners can use in assessing the soundness and conservatism of banks' internal risk estimates. These processes are being developed by the agencies but the work here is not final. I raise the issue of validation of risk-estimates today to emphasize that it is important enough to make my short list of threshold issues which must resolved.

There is a second critical dimension to the issue of evaluating bank models and model inputs, and that is the issue of uniform supervisory standards. We must avoid a situation where there are differences in regulatory capital among banks utilizing Basel II

that have nothing to do with differences in underlying risk profiles. An example of such an undesirable scenario would be where Bank A faces higher regulatory capital than Bank B simply because it uses a more conservative approach to measuring the same risks or because its supervisor differs in its approach to implementation. As more banks qualify for Basel II over time, the potential for inconsistent regulatory capital requirements among banks will be magnified.

In Basel II, the quest for supervisory consistency is currently met by the development of lengthy, detailed and comprehensive standards and technical guidance. Basel II relies upon highly prescriptive standards to ensure consistent interpretation and uniformity in application. While these standards have added immeasurably to the Accord's complexity, the fact remains that, even with detailed rules and standards, independent supervisory judgment will be required on a case-by-case basis. The capital requirements generated in a Basel II framework will be driven by the day-to-day rating of credits by lending officers and independent risk management review processes. These processes, although subject to detailed regulatory guidance and related interagency documents, must be assessed on an ongoing basis. Supervisory review and validation of an individual bank's internal rating and grading systems will be necessary, and key aspects of the internal system not fully addressed or foreseen in the written standards will require the exercise of informed examiner judgment.

Given the level of complexity and detail, it is likely that significant differences in application and supervision at the institution level will be unavoidable under Basel II unless the federal banking agencies enhance existing interagency processes and find effective methodologies to ensure a level playing field in the supervisory oversight of Basel II capital allocation systems.

Another example of the need for enhanced interagency coordination is the monitoring and controlling of the procyclicality concerns already identified in the Basel II framework. Procyclicality refers to the tendency of the capital framework to require less regulatory capital in "good times" and more regulatory capital in "bad times" possibly exaggerating phases of the economic cycle. Basel II's reliance upon banks' internal ratings could result in progressively less capital being assessed during the upswing phase of the economic cycle and conversely, progressively more capital being assessed during an economic downturn. This could result in more expansionary lending during an upswing, thus exaggerating the economic boom. On the other end of the cycle, the capital requirements could constrain the supply of credit and further an economic decline. As a result, minimum capital requirements under Basel II may tend to reach their low point at the height of the economic cycle, when a peak has been achieved and a strong economy is on the verge of a downturn.

Under Basel II, supervisory control and oversight is relied upon to moderate any negative side-effects of this procyclical capital framework. It is essential that the federal bank regulators closely coordinate their consideration of procyclicality under Basel II and develop uniform and transparent supervisory responses and guidance. From the FDIC's standpoint as deposit insurer, participation and input into these capital adequacy deliberations will be a high priority.

Thus far, my discussion of uniform supervisory treatment has been confined to the Basel II banks. Resolving these issues will be critical for ensuring safety and soundness, and for maintaining the credibility of our large bank supervision programs. From the standpoint of public policy towards the U.S. financial system, however, another issue could loom even larger - the issue of competitive equity between Basel II banks and other institutions.

Basel II will most likely be mandatory only for a group of large, complex and internationally active U.S. banking organizations. This mandatory group of institutions does not include numerous large regional banking institutions, as well as thousands of smaller, community-based banks and thrifts. Basel II banks will compete with other institutions for business ranging from large corporate customers to small business loans, credit cards and mortgages. If Basel II provides the largest U.S. institutions some material economic advantage as a result of lower capital requirements, the "non-Basel" institutions may find themselves at a competitive disadvantage in certain markets. Lower capital requirements could give "Basel banks" an advantage in the pricing of loans, the ability to leverage, or the cost of capital. Some banks also have expressed a concern about the impact of being considered a "second tier" institution by the market, rating agencies, or sophisticated customers such as government or municipal depositors and borrowers. If significant, such disparities could accelerate the trend towards industry consolidation.

For these reasons, Basel II is potentially relevant to a larger universe of banks than those that may wish to qualify. With respect to how relevant the competitive effects will be, bankers know who their competitors are and will need to decide for themselves the potential impact on their businesses. Thus far, the documentation of Basel II has been largely technical and conceptual in nature. The work of translating the technical material into dollars-and-cents information about the capital that a bank or its competitor may be required to hold will, consequently, be very important for purposes of facilitating informed comment. We have worked to 'demystify' the Accord with a symposium on the Basel II process last summer in New York and with a series of informational papers, beginning last month, on various aspects of the Accord. We will continue this effort in the months ahead.

In summary, the threshold issues that must be addressed before the U.S. implements the proposed Basel II Accord are: (1) assuring appropriate minimum capital standards for banks regardless of the results of the models; (2) establishing a consistent supervisory process for ensuring that banks' internal risk estimates are sound and conservative; and, (3) vetting any potential competitive effects with all interested persons.

Implementation Issues

Presuming these threshold issues are satisfactorily resolved, numerous Accord implementation issues still need to be decided. This testimony concludes by touching briefly on a few of these issues: the operational risk capital charge, the complexity and burden of the new Accord, and the scope of its application.

Operational risk is defined as the risk from breakdowns in technology, systems or employee performance (including fraud), and spans a wide range of significant risk exposures to banks. Many recent bank failures were directly tied to fraud, and most included some failure of internal controls. Since the conclusion of the savings and loan crisis, the single, largest loss to the Bank Insurance Fund resulted from fraud (First National Bank of Keystone, September 1999). The failure of Barings Bank – an insolvency of international consequence - also resulted from fraud and poor internal controls. Fraud contributed to eight of the eleven U.S. bank failures in 2002 and was the direct cause of failure in several of these cases. In short, major operational losses caused by external or internal fraud or breakdowns in internal controls are, regrettably, a common cause of recent bank failures.

We believe a capital standard is not the sole or complete solution to confronting operational risks. Active federal supervision, independent auditors, effective internal controls, and strong bank management are obvious key components of a sound risk management program. It is clear, however, that adequate capital must be allocated for operational risk and, as long as banks hold adequate overall capital relative to the risks they assume, the FDIC's interests will be served.

With respect to the much discussed distinction between Pillar 1 and Pillar 2 treatment of operational risk, it should be noted that the currently contemplated Advanced Measurement Approach provides much of the same flexibility as would a Pillar 2 treatment. It is worth emphasizing, however, that the supervisory imposition of a new and untested science for Pillar 1 measurement of operational risk should not drive significant structural change to the internal risk management processes and control systems in the U.S. banking industry.

The treatment of operational risk is only one aspect of the overall cost-benefit tradeoff that banks will need to assess when deciding whether they wish to join the group of institutions that will use the proposed Basel II approach. In this regard, some bankers have pointedly asked how much capital reduction will be permitted for banks meeting the Basel II standards. I have already discussed the critical significance of where we draw the line in terms of banks' overall capital. It is, nevertheless, defensible that there could be at least some additional capital flexibility granted to banks that have substantially improved their risk-management programs. The question is, how do we identify the necessary improvements that qualify banks for a capital regime that allows for this additional flexibility.

Under Basel II, in order to implement the IRB (internal ratings based) framework, banks will need to obtain and aggregate default and loss data for each type of loan class in their portfolio. The data will need to span a period of several years in order to effectively gauge credit risk through an economic cycle. In addition to the systems that must be developed to fully adopt an IRB framework, banks must also invest in staff expertise, internal controls and make other structural changes driven by the high qualitative standards that append to the Basel II standards.

As a result, compliance with Basel II's IRB framework will require a significant investment in time and resources, systems and people. The entire banking organization could be affected by a conversion to an IRB framework.

The Basel II framework, especially the IRB standards, impose lengthy, detailed and complex requirements. The qualification standards, under development by the Accord Implementation Group for banks required to implement the IRB approach, will add a further layer of complexity and detail. For each level of complexity, an additional increment of burden is added to the regulatory framework. There is, indeed, a demand for complexity as banks seek to have capital tailored to their individual risk profiles. In short, in order to implement Basel II, a greater degree of complexity and associated burden is unavoidable. These burden considerations, and the desirability of testing the waters with the new Accord, suggest that the universe of Basel II banks initially should be relatively small.

Conclusion

The ideal Basel implementation would be an Accord that ensures adequate capital in the system while correcting the deficiencies of the 1988 Accord with respect to the regulation and supervision of large, complex institutions. The new Accord should ensure

that the complexity needed to achieve the necessary risk focus is not so great as to stand in the way of effective implementation or supervision. In addition, it should provide incentives for better risk management and avoid such significant regulatory and capital discontinuities between Basel and non-Basel banks as to tilt the financial services playing field in major unintended ways.

The FDIC will work to ensure these goals are being met as the process moves forward.

Thank you for the opportunity to present the views of the FDIC.

Written Testimony of
David A. Spina
Chairman and Chief Executive Officer
State Street Corporation
Before the
Subcommittee on Domestic and International
Monetary Policy, Trade, and Technology
House Committee on Financial Services
U.S. House of Representatives
February 27, 2003

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify today on issues related to the proposed New Basel Capital Accord. This is an important issue for U.S. banking companies, including State Street, and I appreciate your interest.

I am Chairman and CEO of State Street Corporation, a global financial services company headquartered in Boston, Massachusetts. State Street provides services such as custody, fund accounting, and investment management to public and private investment institutions. Because we specialize in serving institutional investors, we have no traditional retail or credit-oriented banking services --- rather, State Street is part of the infrastructure of the global financial services industry.

As described in detail in this testimony, we believe the Basel Committee's proposal to add a new regulatory capital requirement for operational risk is misguided, and creates competitive disadvantage for U.S. banks. If provided the option, we would not choose to "opt-in" to the proposed new operational risk capital regime. However, based on our significant position in our industry sector, and the international nature of our business, we expect to be required by U.S. regulators to comply with Basel II.

Before describing our objections to the Basel proposal, however, I want make it very clear that:

- We agree with the Basel Committee that operational risk is a critical issue;
- We view the U.S. bank supervisory system as one of the best in the world, which is an asset for U.S. banks. The strength of U.S. supervision, however, also creates challenges as we compete with institutions subject to less intensive regulatory supervision abroad; and
- We believe the U.S. regulators' current efforts to address operational risk through their supervisory authority is working -- and provides a strong foundation upon which to build even better risk management practices.

I will describe the Basel Committee's proposed approach to operational risk in more detail below, but, in simple terms, the proposal would create a new regulatory capital requirement for banks, based on some statistical measure of operational risk. Using the Basel Committee's terminology, operational risk would fall under "Pillar 1," which establishes capital standards, vs. under "Pillar 2," which addresses risk through regulatory supervision. Under the Basel Committee's definition, operational risk is a very broad category, including nearly all risks inherent to conducting a business, with the exception of strategic, business, or reputational risk.

We have serious concerns with the Basel Committee's current proposal to add new regulatory capital requirements for operational risk, and my testimony addresses the following major points:

- Operational risk is a real concern, but should be addressed through supervision and incentives to build operational risk controls, not additional regulatory capital;
- There is a broad consensus that quantification methodologies related to operational risk are underdeveloped and untested;
- Even with the Basel Committee's movement towards the "advanced measurement approach," the operational risk capital proposal remains problematic;
- Focusing regulatory efforts related to operational risk on regulatory capital vs. supervision creates perverse incentives which can undermine effective risk management;
- The Basel Committee's operational risk capital proposal creates significant domestic and international competitive concerns for U.S. banks, creating an unnecessary "tax" on holding a U.S. banking license; and
- U.S regulators have -- and other national regulators should have -- sufficient supervisory tools to address operational risk.

As a result, we believe U.S. regulators should insist that the Basel Committee abandon its current proposed Pillar 1 regulatory capital regime for operational risk and adopt in its place a rigorous, effective Pillar 2 supervisory treatment for operational risk.

Operational Risk: A Real Concern That Warrants Increased Supervisory Attention

Although State Street and many other U.S. banks are strongly opposed to a new requirement for additional regulatory capital related to operational risk, we agree that operational risk is a major issue that warrants supervisory and management attention. We believe an increase in such supervision can, and should, be implemented quickly --- far more quickly than is possible should regulators continue to focus limited regulatory

resources on the complex and ultimately misguided current Basel operational risk capital proposal.

As defined by the Basel Committee, operational risk is the risk of loss related to system or human failures, as well as those resulting from natural or man-made disasters. Operational risk is the natural concomitant of everyday life for a financial services firm, and it is experienced by all companies in the same line of business regardless of the legal charter under which they may operate.

It is important to note that operational risk is quite different from credit risk (that is, the risk that a borrower may not repay a loan). Banks and other lenders can choose to take on more credit risk to increase profit – as is done in subprime lending, for example – recognizing that increased loan losses will be offset by the increased return on higher-risk loans. There is no such "profit-motive" for taking on additional operational risk.

The operational risk-based capital proposal appears to have been drafted with a conventional model of risk in mind, where capital serves to absorb unexpected losses and thus to protect deposit insurance funds and/or central banks. As demonstrated by the tragic events of 9/11, however, managing operational risk requires a different approach.

The events of 9/11 make it clear that operational risk mitigation activities (systems redundancy, contingency planning, disaster recovery, insurance, etc.) are essential and effective mitigants to even the most extreme forms of operational risk. Institutions that invested in operational risk mitigation absorbed the unprecedented shock resulting from the terrorist events with remarkable resiliency. Instead of actively supporting such investments, the Basel Committee's operational risk capital proposal would create a regulatory incentive to divert resources away from such investments, and towards meeting regulatory capital requirements.

It is difficult to see how a regulatory operational risk-based capital rule would have promoted the financial system's rapid recovery on 9/11. Capital would have taken time to access, and systems rebuilding would have taken still more time, delaying the resumption of market activity, and creating significant systemic risk. In contrast, redundant systems in place on 9/11 were quickly able to mitigate the effects of the terrorist attacks.

The differences between credit risk and operational risk argue for a different regulatory approach than is taken in the current Basel draft. Credit risk can be addressed with a quantitative, empirically-based regulatory capital requirement (the "Pillar 1" section of Basel), but operational risk should be addressed solely through effective and enforceable supervision under Pillar 2.

In contrast to its proposal for operational risk, the Basel Committee has decided to continue to address interest rate risk under Pillar 2. While there may be sound reasons to leave interest rate risk under Pillar 2, it is unclear why the Committee does not provide similar Pillar 2 treatment of operational risk. Unlike operational risk, there are accepted definitions of interest rate risk, and measurement of interest rate risk is a well-developed management practice. Interest rate risk is priced every day in the market, where billions of dollars of related derivatives are bought and sold. Like credit risk, interest rate risk is taken on for profit --- and, like credit risk, interest rate risk is a known and proven cause of bank failures. Interest rate risk was the predicate cause of the savings-and-loan debacle that cost this nation's taxpayers more than $250 billion in the 1980s.

Still, the Basel Committee's proposal leaves the known, measurable interest rate risk in Pillar 2, even as operational risk – far less well defined and generally not assumed for profit – is being pushed into Pillar 1.

Problems with Regulatory Capital for Operational Risk Are Well Recognized

State Street is not the only bank with deep concerns about the Basel Committee's operational risk proposal, nor are banks the only ones opposed to the proposed Basel Pillar 1 approach. Since the Basel Committee released the first version of its operational risk proposal in 2001, many banks have commented on the need to consider operational risk as part of Pillar 2, and operational risk remains one of the most controversial elements of the Basel Committee's proposed New Capital Accord.

These concerns are echoed by a number of recent statements, including one from the Basel Committee's sister panel, the Committee on the Global Financial System, which is chaired by Federal Reserve Board Vice Chairman Roger Ferguson. In a January, 2003 assessment of the prospects for credit risk transfer, the Global Financial System Committee found:

> "[Operational and liquidity risk] are more difficult to measure than credit and market risk, and it may be difficult to deal with them in quantitative capital rules and disclosure standards. A more qualitative approach, focusing on risk management, may be needed."

The Financial Services Authority in the United Kingdom has also voiced concerns in its own supervisory approach to operational risk. Although a signatory to Basel, the FSA noted in its own pending standards for operational risk:

> "... due to both data limitations and a lack of high powered analysis tools, a number of operational risks cannot be measured accurately in a quantitative manner at the current time."

Speaking about implementation of the operational risk-Based capital requirement in the European Union, a major policy-maker from the FSA has indicated that the EU's Capital Adequacy Directive may take a different – and more lenient – approach to operational risk-based capital than Basel.

Finally, U.S. regulators remain at odds about the value of a Pillar 1 approach to operational risk. In its formal comments to Basel in 2001, the Federal Reserve Bank of Chicago rightly noted:

> "In part [the operational risk requirement] appears to be due to concerns not about operational risk per se but that making market and credit risk more risk sensitive will permit some banks to hold too little capital...We are concerned...that basing capital charges for operational risk capital on business activity provides little incentive to manage these risks."

On June 6, 2002, in remarks to the Risk Management Association, Comptroller of the Currency Hawke said:

> "A one-size-fits-all approach to operational risk — such as a formulaic capital charge based on some percentage of gross revenues or a percentage of the charge for credit risk — while simple to apply, would disadvantage the best managed banks and provide undeserved advantage to the worst managed. Worst of all, it would provide no incentive to improve internal control systems...I've repeatedly argued that operational risk is a subject peculiarly appropriate for assessment under the Pillar 2 approach -- an approach that relies on supervisory analysis rather than numeric formulas."

Current Pillar 1 Approach Remains Problematic

The most recent version of the Basel operational risk-based capital proposal includes three options:

- a "basic-indicator" capital requirement based on a percentage of a bank's overall gross income;
- a "standardized" requirement assessed on gross income on a line-of business basis; and
- an "advanced measurement approach," or AMA, which relies on internal risk models.

Each of these options has grave conceptual and methodological flaws.

The "basic-indicator" and "standardized" approaches' reliance on gross income (which we read to approximate total revenue) is simply misguided. There is no empirical data that suggests that operational risk bears a linear relationship to gross income, and our experience at State Street suggests that the two factors are not related. Without such data, reliance on gross income as a capital driver is contrary to the Basel Committee's goal of making the capital regime more risk-sensitive.

A gross income-based operational risk-based capital rule is analogous to the old leverage capital standards, which the first Basel Accord eliminated. Gross income is no more an indicator of real operational risk than gross on-balance sheet assets were of credit risk. Measurement of operational risk along these lines is a backward step in the Committee's overall capital methodology.

In addition, the use of gross income as a risk indicator creates a strong incentive for banks to reduce their investments in operational risk mitigation. Under the "basic-indicator" and "standardized" approaches, banks will bear the same capital requirement regardless of the very significant differences in net income that result when banks make prudent investments in costly insurance, back-up systems, distributed processing, and the other forms of operational risk mitigation. Further, gross income does not reflect the prudent reserves that institutions operating under a robust Pillar 2 framework should establish for defined operational risks.

Reliance on gross income, in essence, fails to reward (through lower capital requirements) banks that choose to lower net income through significant investment in operational risk management and mitigation.

The "standardized" approach, which assesses capital based on gross income on a business line basis, suffers from additional flaws. The Basel Committee's delineation of business lines conflicts with those adopted by many banks for strategic reasons, creating additional complexity and implementation issues.

Reflecting the many measurement and policy issues in the original Basel Committee approach to operational risk-based capital, the latest information from Basel indicates that the next version of the Basel proposal will contain significant revisions to the initial one issued in January 2001.

The Basel Committee, at the urging of U.S. regulators, is now proposing that banks have the option to assess capital based on an "advanced measurement approach" (AMA), under which internal models would play a major role in determining regulatory capital. Recently, U.S. regulators have indicated that they are now considering requiring that all U.S. banks subject to the operational risk-based capital proposal use the AMA approach.

Unfortunately, while an improvement over the 2001 Basel Committee proposal, the AMA is equally unworkable, and raises many of the same conceptual and policy-related issues raised by the more basic operational risk quantification methodologies.

To the extent that the AMA relies on a bank's internal models and loss data, it is an improvement over the Basel Committee's far cruder assumption that operational risk is linearly related to gross income. However, while some of the concepts underlying the AMA may be useful in evaluating capital adequacy under Pillar 2, they are far too underdeveloped and untested to form the basis for a regulatory capital requirement under Pillar 1.

There are considerable technical challenges to implementing a Pillar 1 capital requirement using AMA. For example, the AMA requires the use by banks of outside data as a supplement to internal data. Useful outside data is sparsely available, and often inconsistent. Integrating such external data into an AMA model in a useful manner will be very difficult, requiring scaling for a wide variety of factors related to product lines, control environment, and the scale of activity. Well managed institutions will face special challenges, as their lack of loss data due to sound management practices will result in requirements to seek out and import irrelevant loss data from other, less well run, institutions. As with many other aspects of operational risk quantification and measurement, the integration of such data is highly experimental and unproven. As a result, any capital requirement based on the AMA will be equally suspect, and creates a high risk of severe -- but misguided -- regulatory penalties for failure to meet Pillar 1 regulatory capital thresholds.

While the technical challenges related to AMA are daunting, the more significant flaws to the Basel Committee's Pillar 1 proposal are more conceptual. The primary substantive argument for including operational risk as part of Pillar 1 appears to be a desire for even and transparent application of operational risk regulation between institutions, and across jurisdictions. The very nature of the AMA, however, will result in just the opposite outcome.

The AMA is highly complex, and depends on a wide variety of highly subjective assumptions. Imposing a capital requirement based on the AMA will require tremendous amounts of supervisory guidance and scrutiny. Even then, ensuring consistency between banks and jurisdictions will be nearly impossible. The very subjective nature of the AMA, combined with the very nascent state of operational risk quantification methodology, invites "gaming" between jurisdictions --- an outcome we assume the Basel Committee is attempting to avoid.

The subjective and experimental nature of the AMA requires adoption of a more flexible approach than that dictated by a Pillar 1 regulatory capital measurement. Capital

adequacy related to operational risk is important, but can be far more suitably addressed through a Pillar 2 supervisory approach.

In sum, each of the options offered by the Basel Committee for calculating additional regulatory capital for operational risk is deeply flawed.

Potential Perverse Regulatory Incentives Undermine Effective Risk Management

An explicit addition to regulatory capital for operational risk that fails to take account of risk mitigation would create a perverse incentive for banks to shed insurance, eliminate reserves and reduce expenditures dedicated to operational risk mitigation. As noted, the difficult and tragic experience of the financial services industry in the wake of the World Trade Center attacks makes it clear that incentive-compatible regulation should emphasize, not run counter to, effective operational risk mitigation. Quite simply, no amount of operational risk-based capital would have been enough to bring the U.S. financial system back on-line as quickly as occurred after the September 11 attack.

Less cataclysmic instances of operational risk also point to the critical importance of effective risk mitigation, and the fact that an operational risk-based capital requirement would have little impact on either preventing or correcting problems. The most often cited possible case of a bank failure related to operational risk is that of Barings in 1995. As is well known, the centuries-old British bank failed due to the lack of fundamental and basic operational risk management techniques. Ultimately, these losses amounted to £850 million -- far in excess of the approximately £82.5 million the bank would have added to its regulatory capital under the Basel Committee's current proposal.

Would this additional capital requirement have prevented the rogue trading? Of course not, but effective internal controls and independent reporting lines would have done so – and effective supervision would have ensured that things were in place to prevent such catastrophic losses occurring without detection by the bank or its supervisors.

Major Competitiveness Concerns

Addressing operational risk through additional regulatory capital requirements, as contemplated by the Basel Committee, would have significant domestic and international competitive impacts on U.S. banks.

First, U.S. banks compete in a number of business lines with non-banks.

For example:

- In investment management, banks compete with companies such as Fidelity and Vanguard.
- In fund accounting and financial technology, banks compete with firms such as BISYS, SunGard and SEI Investments.
- As payments processors, banks compete with First Data, NPC, and Nova Information Systems.
- Banks compete in numerous areas with non-bank financial institutions, such as broker-dealers.

These are just a few examples -- and it is precisely these business lines where the Basel operational risk proposal will have the most detrimental effect.

In the U.S., only banks are subject to the current bank capital rules, and only banks will be subject to the new capital requirement for operational risk. Although the European Union hopes to impose the Basel capital regime on many non-banks, it is not possible for U.S. regulators to do, due to both statutory restrictions and the strong opposition of non-banks to the possibility of being forced under the Basel capital rules.

The result under the Basel proposal is an uneven playing field -- creating an unnecessary "tax" on banking licenses, and a competitive disadvantage for banks.

Second, the Basel Committee's operational risk proposal will hurt U.S. banks in the international marketplace. U.S. banks dominate the global market for services such as custody and investment management. The rigorous supervision of banks by U.S. regulators is an important element in this success.

The Basel Committee's proposed treatment of operational risk, however, does not play to the strengths of the U.S. regulatory system. Instead, the proposal is a "lowest common denominator" approach, reflecting the inability of many overseas regulators to supervise and examine banks rigorously. As a result, the proposal attempts to quantify operational risk with questionable statistical models, instead of more appropriately focusing on risk management processes and procedures.

The result is a proposed regime, where, for example, capital requirements for legal risk will place a greater burden on U.S. banks than their overseas competitors. In addition, certain laudable features of the U.S. regulatory system that have not been adopted in other jurisdictions -- such as the "prompt corrective action" regulations and frequent on-site examinations -- create very serious repercussions for U.S. banks that fail to meet regulatory capital ratio thresholds which are well above the minimum ratio requirements. As a result, U.S. banks will face far more serious regulatory consequences from errors introduced into regulatory capital calculations by admittedly imprecise operational risk capital assessments.

Finally, U.S. banks simply have no confidence that the Basel rules will be applied evenly in all jurisdictions.

The experience with Japanese implementation of the 1988 Capital Accord is instructive. Japanese regulators exploited numerous loopholes of the 1988 Accord -- and then simply did not require banks to write off bad loans. The result was nominal -- but fictional -- compliance with the Accord.

Similarly uneven application of a new operational risk requirement will have serious competitive impacts for U.S. banks.

Imposing new capital requirements for operational risk may create unintended pressure for U.S. banks to consider conducting business under other, non-bank forms of organization. Should major U.S. providers of investment management and similar services abandon their banking charters, systemic risk would likely increase. Appropriate supervision of operational risk would create a far sounder systemic framework without introducing new incentives for institutions to operate outside the bank regulatory system.

U.S. Regulators Have – and Others Should Have – Supervisory Tools to Address Operational Risk

As noted, State Street believes that operational risk is a major issue that can be far better addressed through effective supervision (Pillar 2) than an unproven, inappropriate, and technically flawed Pillar 1 regulatory capital requirement. We strongly support the most recent Basel "Sound Practices Paper" proposal for operational risk and urge quick action on it.

One of the arguments U.S. regulators have used in defense of the Basel Pillar 1 approach is that they lack the tools to ensure effective operational risk management. As a U.S. bank, operating under the supervision of U.S. regulators, we disagree. Bank regulators have been provided wide powers and discretion by Congress, and can impose sanctions for any practice that does not meet standards for safety and soundness. Congress recently gave U.S. bank regulators even more power to ensure effective risk mitigation. The Gramm-Leach-Bliley Act allows only financial holding companies that meet the standards for being both "well managed" and "well capitalized" to retain financial holding company status. Recently, the Federal Reserve and OCC denied this status to a large regional bank due to a combination of problems, including failures to manage certain operational risks. The bank moved quickly to correct these problems, as have others fearing similar sanctions.

In many cases, regulators in other nations lack the strong supervisory resources enjoyed by U.S. regulators. It is sometimes argued that a Pillar 1 approach is necessary to ensure improved operational risk management in these nations. The lack of supervisory resources in other nations, is, however, not sufficient to justify the negative impacts of a Pillar 1 operational risk approach. Supervisors around the world should instead be encouraged to develop the supervisory ability to implement a strong Pillar 2 approach to operational risk -- an ability already present with U.S. regulators.

Finally, some have argued that the simple threat of the operational risk-based capital requirement has led banks to improve operational risk measurement and management. As noted above, however, U.S. regulators already have ample resources to push U.S. banks to improve operational risk management, and foreign regulators can and should focus on operational risk management, not simply levels of regulatory capital.

Conclusion

We urge Congress to carefully consider that:

- Despite the adoption of the potentially improved Advanced Measurement Approach to calculating operational risk-based capital, the Basel Committee's operational risk capital proposal remains unworkable;
- The operational risk capital proposal creates a perverse incentive against banks' investment in systems, processes, and people to avoid operational losses;
- The Basel Committee's operational risk capital proposal creates unnecessary competitive disadvantage for U.S. banks competing with non-banks, and with non-U.S. competitors;
- U.S. regulators have sufficient supervisory authority to require strong operational risk management practices, including the evaluation of capital adequacy – and other national regulators should be given similar authority; and
- Operational risk would be far better addressed through a Pillar 2 supervisory approach.

We urge Congress, and the U.S. banking regulators, to consider the negative impact of the Basel Committee's operational risk capital proposal on U.S. banks, and to work towards a more suitable Pillar 2 supervisory regime for operational risk management regulation.

CAROLYN B. MALONEY
14TH DISTRICT, NEW YORK

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Congress of the United States
House of Representatives
Washington, DC 20515–3214

August 14, 2002

Alan Greenspan
Chairman
Federal Reserve System Board of Governors
20th Street & Constitution Ave, NW
Washington, DC 20551

John D. Hawke
Comptroller of the Currency
OCC
250 E Street, SW
Washington, DC 20219

Donald Powell
Chairman
FDIC
550 17th Street, NW
Washington, DC 20429

Dear Chairman Greenspan, Comptroller Hawke, and Chairman Powell:

I am writing to you regarding an issue of great importance to many Members of Congress: the work of U.S. banking regulators to update the Basel Capital Accord.

I strongly endorse a capital framework that will ensure the safety and soundness of our financial system. I am concerned that the Accord, as currently proposed, may impose unjustified costs on U.S. financial institutions. Given the globally competitive nature of the financial services industry, I am concerned that these costs could undermine the competitiveness of U.S. institutions without providing any reduced risk. Additionally, continued work on the operational risk-based capital charge could lead to problems in adoption on the necessary refinements to the rules governing credit risk and I urge you to resist imposition of any such capital charge. Rather, U.S. regulators should devote their expertise to improving domestic and international operational risk management standards so that the global financial system is better prepared for future terrorist attacks or other threats to the financial system on which the economy depends.

I am sure you agree that the U.S. banking industry's regulatory capital and supervisory framework is among the world's strongest. I recognize that depository institutions need to apportion capital for risk. However, I am concerned that the capital charge for operational risk is unmerited and arbitrary. I am aware of no U.S. bank that has failed due to operational risk.

I have yet to hear a convincing argument that a capital charge for operational risk would improve risk management practices. A capital charge for operational risk may even create a perverse incentive against costly operational risk mitigation, thereby increasing both institutional and systemic risk. As a representative from New York City, this possibility particularly concerns me given the instrumental role existing risk mitigation played in speeding the reopening of financial institutions following the attack on the World Trade Center. I would rather see banks devote their financial resources to make certain systems and procedures are in place to monitor and prevent this risk than to meet the requirements of an unnecessary capital charge.

As you continue to work on the update of the Basel Accord, I urge you to resist revisions that include a specific regulatory capital charge for operational risk. An Accord with such a provision would be objectionable to many Members of Congress, which could delay adoption of overall revisions to the financial systems' risk-based capital rules that are needed to promote safety and soundness in the United States and around the world.

Sincerely,

Carolyn B. Maloney

CAROLYN B. MALONEY
Member of Congress

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 6, 2002

The Honorable Carolyn B. Maloney
United States House of Representatives
Washington, D.C. 20515-3214

Dear Congresswoman Maloney:

I am pleased to respond to your letter of August 14 regarding the operational risk charge in the proposed revisions to the Basel Capital Accord. While the OCC supports the overall direction of the proposed revisions to the Accord, we have also expressed concerns about certain aspects of the proposed revision, especially the treatment of operational risk.

I have consistently advanced the position before the Basel Committee that any charge for operational risk should be committed to the discretion of bank supervisors, under "Pillar II" of the proposal, rather than being calculated through a formulaic approach under Pillar I. Since operational risk inheres in the quality of an institution's internal control systems, a Pillar II approach, under which supervisors could make a qualitative evaluation of such systems, has always seemed particularly appropriate to me. Hard-wired, "one-size-fits-all" formulas, by contrast, would penalize those institutions with the best control systems, while unfairly advantaging those with the worst, while providing no incentives for improvement. I regret to say that I have not been able to persuade the Committee as a whole to adopt this approach.

Having said this, however, I should also say that I do believe that operational risk should be addressed in some appropriate way in a revised Accord. As events in recent times have confirmed, internal control deficiencies, external and internal fraud, system breakdowns and other similar "operational" risks can result in significant financial losses, undesirable earnings volatility and reputation damage for individual institutions. One need only recall the demise of Bank Herstatt and Barings to see what can happen to a financial institution in extreme cases. The challenge for the Basel Committee and bank supervisors is to identify the appropriate response to those risks, whether through a focus on enhanced risk management, additional capital requirements or other actions.

While the adoption of a Pillar II approach to operational risk does not seem likely, the OCC has worked hard to rationalize and improve an approach under Pillar I, and I am pleased to say that

over the past few months these efforts have resulted in significant and important changes to the proposal relating to this subject. Specifically,

- The Basel Committee abandoned the idea of imposing a "floor" on the capital requirement for operational risk.

- The U.S. regulators decided not to implement the proposed "Standard Business Line" approach for operational risk, with its standardized business lines and loss factors.

- The Basel Committee endorsed a revised "Advanced Measurement Approach" (AMA) for operational risk, which incorporates significant additional flexibility for banks in the development of operational risk measurement and management systems.

I believe these changes have significantly improved the operational risk portion of the proposal. They place an increased focus on the risk management standards and processes within institutions, the importance of which your letter recognizes. The AMA approach establishes a direct link between the bank's risk management capabilities and its capital charge, providing an incentive for continual improvement in risk management practices. The overall capital calibration of the operational risk charges and the recognition of numerous possible qualitative adjustments by individual institutions within the AMA are designed to encourage banks to develop effective risk management systems and risk mitigation techniques. In addition, the AMA approach compels a more structured assessment of contingency plans and other threats to the financial system, and recognizes the early stage of development of more sophisticated approaches to analyzing and managing operational risk. These changes should provide much of the flexibility that we had hoped would be achieved under a Pillar II treatment of operational risk.

The OCC continues to believe that additional dialogue with the industry and other interested parties is critical in ensuring that this proposal appropriately addresses the operational risk in the financial system. In that regard, the OCC and representatives of the Federal Reserve System have met with individual institutions to discuss both the operational risk proposal and operational risk measurement and management techniques currently employed by institutions. A critical next step is the planned Quantitative Impact Survey (QIS) developed by the Basel Committee in conjunction with national supervisors. The QIS is designed to allow institutions to perform a concrete and comprehensive assessment of how the proposed new Capital Accord will affect individual banks. It is expected that the QIS will officially commence this fall.

Ultimately, the decision on the specific elements of the proposed new Accord, including operational risk, will be made after a full consideration of the results of the QIS and other comments and reactions from banks and other interested parties. The OCC will continue to focus on the operational risk proposal to ensure that it retains appropriate flexibility for banks to develop effective operational risk measurement and management systems without unduly affecting insured depository institutions relative to their non-bank competitors.

The OCC would be happy to discuss these and any other Basel Accord-related issues with you or your staff at your convenience.

Sincerely,

John D. Hawke, Jr.
Comptroller of the Currency

cc: Alan Greenspan, Chairman, Federal Reserve Board of Governors
William McDonough, President, Federal Reserve Bank of New York
Donald Powell, Chairman, Federal Deposit Insurance Corporation

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February 27, 2003

The Honorable Peter T. King
Chairman
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On behalf of The Bond Market Association[1] (TBMA), I would like to thank you for holding a hearing on the New Basel Capital Accord (Basel Accord). We are grateful for the opportunity to submit for the record several comment letters we have previously submitted to the Bank for International Settlements' Basel Committee on Banking Supervision (Basel Committee).

As reflected in these comment letters, TBMA's focus throughout the Basel Accord revision process has been on the impact the new guidance would have on securitization transactions, on one hand, and collateralized transactions (principally including repurchase agreement and securities lending transactions), on the other.

The attached letter of January 14, 2003 focuses on securitization-related issues in the proposed Basel Accord. These views were developed principally by the memberships of the American Securitization Forum[2] and European Securitisation Forum[3], two adjunct industry forums sponsored by TBMA.

We support the Basel Committee's objective of aligning regulatory capital requirements more closely with the actual credit risk inherent in securitization exposures. However, as currently formulated, in several important respects the

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[1] The Association represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. Association member firms account for in excess of 95 percent of all primary issuance and secondary market activity in the U.S. debt capital markets, including the issuance underwriting and trading of securitized investments.

[2] The American Securitization Forum ("ASF") is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on transactions involving securitizations. More information about the ASF, its members and activities may be obtained from the ASF website at www.americansecuritization.com.

[3] The European Securitisation Forum (the "ESF") was established to promote the continued growth and development of securitisation and to advocate the positions and represent the interests of the securitisation market throughout Europe. The ESF has a diverse membership from across Europe which includes banks, securities houses, issuers and originators, investors, trustees, rating agencies, legal and accounting firms and other professional participants active in the European securitisation markets. More information about the ESF, its membership and activities, can be obtained from its website at www.europeansecuritisation.com

securitization proposals do not align risks with regulatory capital in a sufficiently accurate or sensitive manner.

In summary, our principal concern is that the current proposals would require banks to hold too much regulatory capital against securitization positions in certain cases—whether evaluated in absolute terms or in comparison with the proposed treatment of corporate exposures that present the same credit risk. No compelling basis has been advanced to discriminate against securitization positions in this fashion. If not amended, the Accord would inhibit the use of securitization as a funding tool and would increase borrowing costs for consumers and businesses.

THE BOND MARKET ASSOCIATION

The attached letters dated May 30, 2001 and May 17, 2002 focus on credit-risk mitigation issues in the proposed Basel Capital Accord, particularly in connection with their effect on the repurchase (repo) and securities lending markets. As set out in the May 2001 letter, these markets are vital to the continued liquidity of the financial marketplace by allowing financial institutions a flexible and stable means of financing their purchase of securities. These products are also vital to the open market operations of the Federal Reserve.

We applaud the goal of the Basel Accord to allow financial institutions the ability to more closely tailor risk-based capital requirements to the actual amount of risk present in financial transactions. We believe, however, that the proposed Accord does not currently meet this goal because under the proposal, institutions would be required to maintain a higher level of capital than is warranted by the practical risk of their positions.

In this regard, we believe that allowing financial institutions to utilize internal risk models to determine counterparty risk for collateralized transactions is a step in the right direction. The Basel Accord should also, however, dictate rigid rules as to what models financial institutions must utilize in determining risk. In addition, the Accord should allow national supervisors under Pillar 2 of the Basel Accord to review and approve the validity of a financial institution's model created by such financial institution. Otherwise, financial institutions would likely devote resources to creating a model which may not accurately capture the risks present in collateralized transactions, and unnecessarily create and conduct such backtests for such models. (In this case, backtesting refers to evaluating the performance of a model based on historical data.)

In addition, the Accord should better reflect the broad manner of ways financial institutions currently obtain legal comfort for the enforceability of their collateral arrangements as well as anticipated legal developments which will mitigate the legal risk associated with these products.

Finally, as stated in the attached letters, we believe the proposed Basel Accord should provide incentives for financial institutions to develop better credit risk mitigation techniques. In this regard, we believe that the proposed Accord should recognize the

setoff of exposures across different products, such as between repo and derivatives transactions, beyond merely allowing setoff between repo and securities lending transactions as currently contemplated.

THE BOND MARKET ASSOCIATION

The collective memberships of the Association, the ASF and the ESF again thank you for the opportunity to contribute these comment letters to today's hearing record. We would welcome the opportunity to discuss these issues further with you or your staff.

Sincerely,

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THE BOND MARKET ASSOCIATION

May 30, 2001

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Ladies and Gentlemen:

The Bond Market Association (the "Association")[1] appreciates the opportunity to comment on the proposed New Basel Capital Accord (the "Proposal").

Our members include financial institutions that are major participants in the securities financing markets, and in particular actively engage in repurchase ("repo"), securities lending and margin financing transactions. This letter provides our comments regarding the impact on such transactions of the Credit Risk Mitigation provisions of the Proposal, and primarily addresses those provisions in the Consultative Document entitled "The Standardised Approach to Credit Risk" (the "Standardised Approach"). This submission

[1] The Association represents securities firms and banks that underwrite, distribute and trade fixed income securities, both domestically and internationally. The Association's member firms are actively involved in the funding markets for such securities, including the repurchase agreement and securities lending markets. Further information regarding the Association and its members and activities can be obtained from our web site (www.bondmarkets.com).

is intended to supplement the Association's preliminary comments as set out in our initial comment letter, dated May 2, 2001 (the "Initial Comment Letter").[2]

While the Association understands the desire of the Committee to finalize the Proposal by the end of 2001, it is increasingly becoming apparent that such goal may be impossible to reach given many of the completely new or incomplete concepts set out in the Proposal.[3] This is particularly so in light of the fact that, as discussed in more detail below, the Proposal as currently drafted does not accurately reflect the low-risk nature of funding transactions, and may have the unintended consequence of increasing systemic risk. Given the potential effect of the Proposal, the financial industry and the Committee should continue their dialogue regarding the Proposal beyond the May 31, 2001 deadline, and, if necessary, past the year end deadline the Committee has set for finalizing the Proposal. It is clear that further discussion between the Committee and the industry is required to ensure that the final Proposal accurately captures the actual economic risks of the financial institutions it is designed to regulate, and has the intended neutral effect upon actual capital requirements for this industry. To the extent provisions in the Proposal undergo substantial revision, the Committee should publish interim drafts of the Proposal for industry comment, even if the year end deadline for finalizing the Proposal is not met. In this regard, the Association stands ready to continue to provide the Committee with input from our member firms regarding the Proposal.

Of particular importance to the Association is the issue of application of the credit risk mitigation aspects of the Proposal to trading book activities of financial institutions. In certain jurisdictions that have implemented the current Accord, such as Europe through the Capital Adequacy Directive, funding transactions are treated as trading book activities. We understand that the Committee intends to provide further guidance on the issue of counterparty risk in the trading book in the form of an interim paper. The Association feels strongly that all elements of the Proposal applicable to the banking book should not automatically be applied to the trading book without a great deal of careful review and consultation with the industry. Funding transactions underpin a considerable degree of liquidity in the securities markets generally and it is important that the Committee avoid magnifying any unintended adverse consequences on market liquidity through application of the Proposals in their present form to trading book activities without any adjustment. Were the Committee to decide to apply the Proposal to funding transactions in the trading book, the Association strongly recommends providing national regulators broad latitude in approving risk-based models for determining capital requirements for such transactions.

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[2] Please also note that, under separate cover, the Association will submit a comment letter regarding the Proposal's impact on asset securitization.

[3] For example, the Association received a letter dated May 24, 2001 from the Financial Services Authority (FSA) asking for industry input regarding how the netting of funding transactions should be addressed in the Proposal. While we commend the FSA for their foresight in calling attention to this important issue, this letter demonstrates that netting of funding transactions is not addressed in the Proposal, and evidences the fact that it is still a work in progress. The incomplete nature of the Proposal is further demonstrated by the pending publication of an interim paper by the Committee to address counterparty risk in the trading book.

EXECUTIVE SUMMARY

Repo, securities borrowing and lending and margin lending transactions are critical to the financing and efficient functioning of the securities markets, and employ a high level of credit risk mitigation practices. The daily volumes for these transaction types are enormous.[4] Nonetheless, losses from credit or operational exposures have been nominal. In the main, the securities supporting these transactions are traded in highly liquid markets providing market valuations throughout the course of the trading day. Supporting significant sectors of these markets are centralized clearance facilities and common systems for the transfer of information. Financial institutions mitigate credit and operational risks through the rigorous application of daily procedures for the evaluation and transfer of collateral to cover unsecured exposures and by common reliance on industry-recognized documentation.

We commend the Committee for making such a significant effort to more closely align regulatory capital requirements with economic risks, while also seeking to minimize the effect on the overall level of capital financial institutions must hold. However, we are concerned that, in the repo and securities lending markets, these goals will not be achieved if the Proposal is adopted in its present form. In our view, the Proposal does not sufficiently take into account the safety, liquidity and sound risk management practices that are characteristic of these markets. The resulting effect of the Proposal would be a regulatory scheme that does not reflect the low level of risk in funding transactions, and substantially increases capital costs for certain funding transactions. This effect runs contrary to the stated goal of the Proposal to "deliver a more risk-sensitive standardized approach that on average neither raises nor lowers regulatory capital for internationally active banks" (Paragraph 7 of the Overview of the Proposal). Given the integral role funding transactions play in providing liquidity to the financial markets, the Proposal will adversely impact such liquidity by raising the regulatory costs of engaging in funding transactions. This adverse impact on liquidity will increase the potential for systemic risk.

The Association respectfully submits the following comments in order to address these concerns. A summary of our comments on the relevant portions of the Proposal are set out below:

1. Generally, we:

   - **Support** the stated goals of the Accord to more closely align regulatory capital requirements with actual economic risk, without effecting an increase in aggregate regulatory capital requirements.

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[4] Data from primary dealers in the United States which report to the Federal Reserve Bank of New York show that the average daily volume of total outstanding repo agreements alone was $2.53 trillion in 2000, an increase of 4.2% from 1999. In Europe, total repo and securities lending transactions settled on one settlement platform (Euroclear) amounted to 95 trillion EUR in 2000.

- **Express significant concern** that the Proposal does not properly recognize the low-risk nature of repo, securities lending and margin lending transactions.

- **Express significant concern** that aspects of the Proposal would impose significant additional regulatory capital costs, as well as impair liquidity, in connection with repo, securities lending and margin lending transactions.

- **Urge** the Committee to consider the adverse effect the Proposal may have on maintaining and encouraging sound risk management practices and on the liquidity and stability of securities markets.

2. On the methodology, level and application of collateral haircuts, we **request that**:

   - The calculation and level of haircuts in the Proposal be substantially revised to properly reflect economic risk levels.

   - Financial institutions be permitted to determine their own haircuts by using internal models of risk calculation.

   - Correlations between securities taken in as collateral and transferred out be recognized for purposes of calculating more accurate haircut levels, and haircuts be reduced where transactions are part of a "matched book."

   - The 10-day liquidation assumption for calculating haircuts be reduced to a more appropriate 3 or 4 days.

   - The Proposal clarify that "liquidation" of collateral occurs upon the acceptance of the offer to sell the collateral or "buy-in" securities.

3. On the *w* factor, we **request that**:

   - The *w* factor be eliminated.

4. On netting, we **request that**:

   - The Proposal permit the netting of repo, securities lending and margin lending transactions as a credit risk mitigant in determining capital charges for credit risk.

   - Haircuts be applied to the net amount of the exposure.

   - Netting be permitted where it is legally effective under master agreements.

   - Cross-product netting be appropriately recognized and encouraged under the Proposal.

5. On the government repo-style carve-out, we:

- **Commend** the Committee's recognition that repo-style transactions should be exempt from the *w* factor and from haircuts.

- **Request that** the carve-out be expanded to recognize a wider range of collateral and transactions.

6. On collateral eligibility requirements, we **request that**:

   - Financial institutions be able to recognize any collateral eligible for inclusion in their trading account.

   - A number of clarifications regarding the risk weighting of cash collateral be adopted.

7. On the legal recognition of collateral, we **request that**:

   - The requirements for the legal recognition of collateral more closely conform to actual market practice.

COMMENT

Background

Repurchase transactions ("repos") and securities loans developed along with the growth of U.S. and international debt and equity markets.[5] As recognized in a recent report, "securities lending is an integral component of nearly all active securities markets, both domestic and international."[6] Repo and securities lending transactions are important to the liquidity and growth of the broader financial markets because they greatly reduce obstacles, such as lack of funding or inability to access needed securities, that many financial institutions would otherwise face when engaging in securities transactions. Ready accessibility to these markets allows financial institutions to finance and hedge their securities positions in an economically efficient, effective, and low-risk manner, as well as to structure flexible trading strategies. In addition, these transactions are frequently utilized by financial institutions because of the flexibility they provide, their operation within a robust legal framework, the high level of market discipline they employ, and the historically low losses associated with such transactions. The liquidity such transactions provide plays an important role in the prevention of increased systemic risk.

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[5] Recent estimates from twelve countries show that the value of repo transactions conducted with government securities alone averaged close to $200 billion (Technical Committee of the International Organization of Securities Commissions (IOSCO), *Securities Lending Transactions: Market Development and Implications*, July 1999).

[6] *Ibid.*

Such transactions increase the liquidity of the broader securities markets by allowing financial institutions to borrow securities on a short-term basis, reducing the potential for failed settlements. In this manner, financial institutions "are able to obtain needed securities by borrowing or by reverse-repos, without an undesirable effect on their inventory management."[7] Many financial institutions also borrow securities to hedge their exposures in offsetting positions they have taken on through derivative instruments. In addition to increasing liquidity in the financial markets, hedging allows financial institutions to further mitigate their risk.

Financial institutions also often act as intermediaries between ultimate borrowers and suppliers of funds, combining repos and reverse repos and securities borrowings and loans into a "matched book." Matched book trading provides another source of funding to a broad range of financial market participants and is indispensable in providing market liquidity for the underlying securities involved in these transactions. Other common forms of repo transactions involve the delivery of funds against securities (a "delivery-versus-payment" or "DVP" transaction). Such DVP transactions are generally much easier to enter into than other forms of secured financing, increasing the appeal and flexibility of such transactions. As such, DVP transactions further facilitate liquidity in the broader financial market by providing funding counterparties a flexible and secured method of obtaining securities and financing.

An overarching appeal of securities lending and repo transactions is their low-risk nature. This low level of risk is a product of effective credit risk mitigation practices, a high degree of market discipline, sophisticated market participants and systems, robust and well-tested legal documentation and a sound legal foundation developed over a period of years. The availability of a flexible yet tested and secured method of borrowing funds greatly reduces the need for financial institutions to use unsecured (and therefore riskier) financing options. Additional risk mitigation is provided through daily revaluation of collateral, or "marking-to-market," by the right to swift re-margining of such collateral in the event of an undercollateralized exposure, and by the ability of counterparties to close out of a transaction promptly in the event such additional margin is not provided. In addition, master agreements provide a robust legal framework for these funding transactions. Such master agreements provide for prompt termination in the event of a default under the agreement (*e.g.*, failure of a counterparty to provide additional margin). The generally short-term nature of funding transactions, many of which are entered into only for an overnight period, also reduces the level of risk.

The low-risk nature of such transactions is demonstrated through the low levels of loss such transactions have historically generated. Internal analyses by many of our members have shown that losses in the repo and securities lending markets have been insignificant over the last decade.

As a result of these advantages that repo and securities lending transactions offer to financial market participants, the use of such transactions has experienced significant

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[7] Bank for International Settlements, *Market Liquidity: Research Findings and Selected Policy Implications*, May 1999.

growth over the past decade. As recently stated by one BIS Committee, "the growth of securities lending [including repo transactions] is attributable in large measure to the positive effects securities lending has had on both investment activity and securities settlement arrangements."[8]

The following credit risk management practices are standard in these markets:

- Daily marking-to-market of contracts to determine net exposures: Trading positions and collateral are marked-to-market on a daily basis to ensure that a counterparty's exposure is adequately collateralized.

- Daily re-margining to eliminate any net exposures: In the event the daily marking-to-market process detects an undercollateralized exposure, a party has the right to call for margin on a same day or next-day basis and margin is required to be delivered on short notice to promptly eliminate such collateral deficit.

- Netting: Counterparties to a funding transaction offset their exposures vis-à-vis one another in order to reduce the amount of exposure one counterparty has to the other. Such netting reduces systemic risk, as it allows a financial institution with a defaulting counterparty to crystallize its exposure and set-off amounts it owes to the counterparty against the counterparty's obligations. In addition, netting provides added protection to the financial institution by reducing its total exposure to an insolvent counterparty. [9]

- Use of master agreements: Standard master agreements have been adopted in virtually every major jurisdiction. The widespread use of agreements such as The Bond Market Association/International Securities Market Association Global Master Repurchase Agreement has helped to foster sound risk management practices for these transactions. Such agreements:

  (1) give the non-defaulting party the right to close-out all transactions under the agreement upon an event of default, including in the event of bankruptcy of the counterparty;

  (2) allow for prompt liquidation of collateral upon an event of default;

  (3) generally give the non-defaulting party or a disinterested third party custodian the right to determine, in good faith, the valuation of securities and collateral even where there is no generally recognized market quotation available;

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[8] *Securities Lending Transactions*, July 1999.

[9] Netting of such transactions receive special treatment under U.S. bankruptcy law. Certain secured creditors may be prevented from quickly liquidating collateral because of the "automatic stay" provisions of the Bankruptcy Code, which impose a halt to liquidation while a bankruptcy trustee determines the priority of each creditor's claim against the insolvent entity. Note, however, that the U.S. Bankruptcy Code provides counterparties to repo and securities lending transactions protection from such automatic stay provisions in the event they are deemed to be a creditor of an insolvent entity. The U.S. laws that govern insolvencies of banks that are not subject to the Bankruptcy Code contain similar protections.

(4) provide for the netting of gains and losses on transactions closed out under a master agreement so that a single net amount is owed by one party to the other; and

(5) are legally enforceable under applicable law, including in the event of the bankruptcy of a counterparty.[10]

In addition, the proliferation of third-party clearing organizations and tri-party custody arrangements has further reduced the level of risk in funding transactions. The development of robust multilateral clearing houses that novate and net exposures (such as the Government Securities Clearing Corporation and the National Securities Clearing Corporation in the U.S.) reduce counterparty risk by ensuring a common creditworthy counterparty and reducing the level of exposure through multilateral netting. The development of soundly managed domestic and international securities clearing systems for prompt settlement of securities through book-entry (such as Euroclear, Clearstream, and the Depository Trust Corporation) further reduces risks involving the operational and settlement aspects of funding transactions. And, in triparty custody arrangements, independent third party custodian banks conduct the valuation, mark-to-market and margin transfer functions, and effect the daily transfers of securities and collateral between the parties' accounts at the bank, thereby minimizing external transfers of cash and securities, and systemic risk.

As discussed in detail below, failure of the Proposal to incorporate capital charges that properly reflect the low risk factors in these transactions would serve as a disincentive to sound risk management practices and could have the unintended effect of encouraging banks to engage in higher risk activities.

Adverse Market Effect of the Proposal

The Association believes that there are aspects of the Proposal, as currently drafted, that could adversely impact funding transactions and the liquidity such transactions provide to the broader securities markets by raising the costs of engaging in such transactions. Analyses by several of our members suggest that the Proposal will result in significantly higher capital costs in certain of these transactions than under the current rules. Comparisons to the current risk-based capital rules in the United States demonstrate that, under the current Proposal, the risk-weight percentages for collateral used in funding transactions will dramatically increase, thereby greatly increasing the regulatory capital costs of engaging in such transactions.

Given the prospect of such higher regulatory costs, the Association is concerned that the level of dealer activity in the funding markets could decrease under the Proposal, leading

[10] The Association, as well as other organizations such as the International Securities Market Association (ISMA) and the International Securities Lenders Association (ISLA), have gathered opinions on certain master agreements published by such organizations in several jurisdictions to evidence the enforceability of such agreements in the event of a bankruptcy of a counterparty.

to reduced liquidity in securities markets. The effect of such reduced liquidity would likely be felt, not only in sovereign debt markets, but by many other markets as well, including the markets for corporate debt, public-sector entity debt, mortgage and asset-backed securities, and equities. Clearly, such an outcome would be contrary to the Committee's intent to provide a more risk-sensitive regulatory structure while not increasing or decreasing the total regulatory cost for financial institutions.

The increase in regulatory capital costs is particularly inappropriate given the historically low levels of risk associated with these types of transactions, as evidenced by the low rates of loss such transactions have historically demonstrated. This outcome directly contradicts the stated goal of the Proposal to more closely align regulatory capital requirements with actual economic risk.

By increasing the costs of engaging in most repo and securities lending transactions, the Proposal will not only reduce liquidity in financial markets, but may also increase systemic risk by, in effect, discouraging the use of such low-risk funding transactions. The smooth functioning of repo and securities lending markets is crucial in allowing financial institutions to meet their obligations to deliver either cash or securities in the broader financial markets, particularly in market stress situations. The imposition of additional costs on these transactions would reduce the liquidity such transactions provide, and thus would potentially magnify the impact of a future market stress situation.

Collateral Haircuts (Paragraphs 86-100 of the Proposal)

As noted in our Initial Comment Letter and restated below under the heading "Expansion of Government Repo-Style Carve-Out," we believe that haircuts should not be applied to those funding transactions or margin lending transactions that are entered into with certain counterparties, employ a high level of credit risk mitigation practices, and involve liquid collateral. However, even for those funding transactions or margin lending transactions where haircuts would continue to apply under our proposed formulation, we believe the proposed calculation methodology and levels of haircuts set out in the Proposal are inappropriate.

The Association applauds the Committee for allowing financial institutions to internally determine collateral haircut values, regardless of whether such institution follows the standardized approach or the internal ratings based approach of the Proposal.[11] The Committee should clarify that the ability to determine haircut levels is open to any bank that is able to create supervisory-approved risk calculation models, regardless of whether such bank is subject to the 1996 Amendment to the Capital Accord to Incorporate Market Risk (the "Market Risk Amendment"). In addition, the methodology used in such models to determine haircut levels for funding transactions should vary in some respects from the

[11] The Standardized Approach states, "a bank's choice between standard supervisory and internal haircuts is independent of the choice it has made between the standardised approach and the foundation IRB approach to credit risk" (Paragraph 129).

internal models approach of the Market Risk Amendment. As set out below, certain assumptions the Market Risk Amendment employs in its calculation methodology do not accurately reflect actual funding market practices. Such practices, in many instances, mitigate credit risk to a greater degree than contemplated under the Market Risk Amendment methodology. Therefore, an approach that simply carries over all aspects of the Market Risk Amendment internal models approach to determine haircut levels for funding transaction collateral would not adequately reward these robust risk mitigation practices, and could actually provide a disincentive to continue to employ and further improve such practices.

One example of how the Market Risk Amendment approach may discourage improved credit risk mitigation practices is the 10-day market movement assumption used to calculate haircut levels. Instead of encouraging the rapid liquidation commonly employed in the funding markets, such 10-day assumption would discourage the prompt liquidation of collateral. Funding market participants would not have an important capital-related incentive to reduce risk by liquidating collateral more rapidly, since they would be required to employ a haircut that assumes a lengthy liquidation period. The liquidation assumption does not therefore reflect the low-risk and prompt liquidation often employed in funding transactions and may actually discourage such credit risk mitigation practice. Such 10-day assumption should therefore be reduced for the calculation of the prescribed haircuts under the Standardized Approach. In addition, financial institutions should be allowed to use a reduced liquidation period assumption in their calculations of haircut levels under the Proposal.

Both the standard supervisory and internally calculated haircuts for funding transaction collateral should instead be calculated based on a much shorter liquidation period, no more than 3 or 4 days. Integral to the low-risk nature of funding transactions is the ability of counterparties to promptly close out of the transaction and liquidate collateral. Unlike other collateralized financial transactions, liquidation can typically be effected in a funding transaction in 3 to 4 days, and often in less than 2 days. Thus, we strongly recommend that any haircuts be determined using this shorter liquidation assumption.

The Committee should also clarify that "liquidation" of a position is deemed to occur as of the time a liquidating party enters into a contract with a new counterparty to sell or purchase the securities. Financial institutions, both in the funding markets and the broader securities markets, view securities as having been liquidated at the time parties agree to purchase and sell such securities, not at the time proceeds are received for such sale. The Proposal should make clear that it intends to follow this prevailing market definition of "liquidation" in determining the length of the liquidation period assumption.

The high level of proposed haircuts also appears to presume a "double risk event," e.g. the risk that the provider of collateral will default in addition to a sudden fall in the value of the collateral. Such risk is small in funding transactions, particularly because the vast majority of such transactions continue to use highly rated foreign sovereign debt or other collateral that exhibits the same qualities as the securities loaned or sold. Given the very small risk of a double risk event occurring, such low level of risk should not be reflected

at all in the haircuts. If a double risk event is to be reflected at all in the haircut values, such haircuts should be calibrated to reflect the very remote possibility of a double risk event occurring in a funding transaction.

The excessiveness of the haircut levels in the Proposal is further evidenced by the fact that they are generally higher than regulatory haircut levels applicable to both banks and other financial institutions that hold such securities as part of their inventory.[12] This is particularly difficult to understand given that risks are lower where securities are held as collateral (i.e., the unlikely "double risk event" scenario must occur in order to have a loss) than where they are held as outright inventory. Haircuts applied to securities collateral should be lower in order to reflect this lower level of risk.

Further, haircuts should not be applied in an additive manner to both sides of a funding transaction. Imposing haircuts on both the securities sold under a repo (or lent in a securities lending transaction) and the collateral received discourages sound collateralization practices. By applying haircuts on each side of a funding transaction in an additive fashion, the Proposal incorrectly assumes a complete negative correlation between securities loaned and the collateral given. In practice, there is frequently a positive market correlation between the securities sold or lent and the securities collateral taken in, and a lack of positive correlation between the issuer of the securities collateral and the collateral provider. Financial institutions engaging in these transactions often have developed models to enable them to take such correlations into account. In addition, such models are frequently used in creating value-at-risk (VaR) models, which themselves are examined by regulators in allowing financial institutions to determine their own haircut levels under the Market Risk Amendment. There is no reason why the use of such correlations should not similarly be allowed under the Proposal. We therefore request that haircut levels under the Proposal, as applied to funding transaction collateral, should recognize such correlations to further encourage sound collateral management practices.

The imposition of haircuts on both sides of a funding transaction has a particularly adverse impact on financial institutions that run a "matched book" and serve an important intermediary role between a lender and ultimate borrower of funds. Financial institutions running a matched book "reverse in" securities collateral and "repo out" such collateral. By acting as both a purchaser and seller of the same securities, such financial institutions would have haircuts applied on the same collateral twice in an additive manner. The application of haircuts in this manner does not take into account the fact that if a counterparty failure causes the financial institution's failure to perform the "matched" contract, the closeout amount owed to the institution should be the same or very similar on both sides of the "matched" transaction. By receiving this closeout amount, the

[12] For example, the maximum level of haircuts on similar instruments mandated for broker-dealers in the United States by the Securities and Exchange Commission is 15%; the most commonly used debt instruments have a haircut of between 0% and 9%. Comparisons cannot be readily made to the Capital Adequacy Directive (CAD) given its calculation of general market risk charges on a portfolio basis. However, even assuming a worst case scenario for the calculation of such haircuts, the haircut levels under CAD are still lower than those proposed under the Proposal, sometimes by as much as 14%.

financial institution is able to largely mitigate or eliminate the loss they would have otherwise incurred. The Proposal does not recognize the reduced risk matched-book transactions present; on the contrary, it presents a punitive structure by applying haircuts twice on the same collateral utilized by the financial institution in its matched book transactions. Instead, as noted above, the Proposal should recognize the positive correlations between the "reversed-in" and "repoed-out" collateral for purposes of applying more accurate, risk-sensitive haircuts to the collateral.

Funding transactions employ a number of credit risk mitigation practices to ensure the prompt liquidation of collateral. Such practices include daily marking-to-market and re-margining. In the event of an undercollateralized exposure, master documentation gives a financial institution the right to immediately close out of a funding transaction and liquidate collateral where additional margin is not provided on a timely basis. These credit risk mitigation practices have proven to be effective, as demonstrated by the historically low levels of loss experienced by the funding markets. The methodology and levels of collateral haircuts for funding transactions in the Proposal should reflect the ability of parties to such transactions to quickly close out in the case of increased unsecured exposure.

_W_ Factor (Paragraphs 84 and 101 of the Proposal and Paragraphs 153-157 of the Standardised Approach)

The Association very strongly believes that the *w* factor should be eliminated from the Proposal. It is unclear which risks *w* is intended to represent that are not already dealt with elsewhere in the Proposal. In addition, as discussed below, and as recognized by the Committee in formulating the repo carve-out provision, many of the risks *w* may potentially represent are not applicable to funding transactions because of the low level of risk involved in such transactions:

- The *w* factor is not sensitive to any specific risk, but is applied across all funding transactions regardless of the credit risk mitigation techniques employed. The *w* factor will apply regardless of the quality of the collateral obtained, the frequency with which such collateral is revalued and additional margin provided, and the ability to close out and liquidate collateral quickly. The *w* factor does not therefore encourage these or other risk mitigation practices, and may actually encourage parties to be more lax in applying such practices, thereby increasing risk.
- Assuming *w* is intended to represent documentation risk, *w* is inappropriate for funding transactions because, as stated above, funding transactions are generally governed by well-established, legally enforceable master documentation. The funding markets recognize the legal stability of repo and securities lending transactions by pricing such transactions without building in a legal-risk component for transactions conducted under such master documentation, and employing common credit risk mitigation practices. Although some litigation risk remains even where there is

legally enforceable documentation, such risk exists in any kind of commercial transaction.

- If *w* is intended to provide a cushion for valuation and liquidation difficulties in the event of market shocks, the combination of daily marking-to-market, daily margining rights and robust legal documentation is designed to target and minimize these very risks. In particular, documentation governing such transactions typically contains provisions which allow the non-defaulting party or a third-party custodian flexibility in obtaining a reasonable market quote or otherwise determining market value for purposes of pricing and liquidating collateral in a funding transaction, even during periods of general market illiquidity. All other potential market risks regarding the collateral are captured in the haircut calculations.

- If the *w* factor is intended to represent a "double risk event," e.g., the combined risk that the provider of collateral will default and there will be a sudden drop in the value of the collateral, this risk (to the very limited extent it exists in funding transactions), is already addressed elsewhere in the Proposal. As noted above, such risk is minimal in funding transactions, particularly because the vast majority of such transactions continue to use highly rated sovereign debt or other collateral that exhibits the same qualities as securities sold or loaned. Any residual risk of a "double risk event" occurring is more than adequately captured through collateral haircuts and the credit risk weighting of a counterparty in respect of net exposure.

As noted above, these markets are characterized by disciplined and effective risk mitigation practices. Notwithstanding periods of market turbulence and illiquidity over the last five years, losses on these products have been insignificant. As noted in a recent BIS Committee report, "repo markets. . .are often relatively resilient and subject to limited credit rationing in periods of market turbulence."[13] Applying a blunt instrument such as *w* to these markets seems contrary to the Committee's stated goal to deliver a more risk-sensitive methodology that neither raises nor lowers overall regulatory capital for financial institutions and motivates financial institutions to improve their risk management practices.

Netting (Paragraphs 112-116 of the Proposal)

The Association has recently received a letter, dated May 24, 2001, from the Financial Services Authority (FSA), asking for industry input as to how netting of funding transactions should be addressed in the Proposal. The Association applauds the foresight shown by the FSA in calling attention to this issue, particularly given the fact that netting of funding transactions is not currently addressed in the Proposal. The Association will provide more detailed comments in response to the May 24 letter in the near future.

[13] *Collateral in Wholesale Financial Markets: Recent Trends, Risk Management and Market Dynamics*, Committee on the Global Financial System, Bank for International Settlements (March 2001).

However, in an effort to respond by the May 31 deadline, we present below our preliminary comments on netting of funding transactions.

As stated in our Initial Comment Letter, the Association believes that the netting provisions of the Proposal should apply to funding transactions for a number of reasons. Most importantly, the netting of exposures between counterparties reduces the level of exposure one counterparty has to another. The resulting reduction of risk also decreases the cost of engaging in such transactions. In the context of the funding markets, such reduced cost has the potential to allow counterparties to enter into additional transactions, which in turn adds to the liquidity of the financial markets as a whole. As noted above, netting also reduces the likelihood of systemic risk, as it allows a financial institution with a defaulting counterparty to crystallize its exposure and liquidate only that collateral which is required to meet the net exposure.[14]

In addition, the Association believes it is important for the Proposal to address the significant disparity that exists today among different jurisdictions in respect of the recognition of effective netting agreements in the capital treatment of funding transactions. Under the national regulations implementing the current Basel Accord and national accounting rules, comparable master securities lending and repo transactions receive quite different capital and netting treatment in different jurisdictions despite the fact that funding transactions are increasingly international. Most notably, the EC Directives and the United Kingdom Financial Services Authority permit the calculation of exposures on trading book repo/reverse repo and securities lending/borrowing transactions on a portfolio basis, with collateral maintained on the exposure on a net basis. In the United States, by contrast, the capital treatment of these transactions follows on-balance sheet treatment under generally accepted accounting principles ("GAAP"); under U.S. GAAP, only limited forms of collateral are recognized and netting is permitted only in very limited circumstances.[15] Therefore, under the current U.S. regime such transactions generally cannot benefit from the current Accord, which recognizes netting only for off-balance sheet items.

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[14] See footnote 9.

[15] Under Financial Accounting Standards Board Interpretation No. 41, a bank may offset amounts recognized as a receivable under reverse repos if:

(1) the repo and reverse repo agreements are executed with the same counterparty;
(2) the repo and reverse repo agreements have the same settlement date;
(3) the repo and reverse repo agreements are executed with a master netting arrangement;
(4) the underlying securities exist in "book entry" form and can be transferred only by means of entry in the record of the transfer system operator or securities custodian;
(5) the repo and reverse repo agreements are settled on a securities transfer system, and the bank has associated banking arrangements in place;
(6) the bank intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both (a) the cash inflows resulting from the settlement of the reverse repo and (b) the cash outflows in settlement of the offsetting repo.

Capital regulations regarding netting should provide incentives to engage in prudent netting practices, and should not necessarily follow the accounting treatment of netted exposures (as is the case in the United States). The Proposal can promote this objective by recognizing net credit exposures whether the transactions are regarded as on-balance sheet or off-balance sheet, or both, or are held in the banking book or the trading book. Haircuts, if applied, should relate to this net exposure. The haircut applied should be based on the average haircut applicable to the collateral.

The repo and securities lending markets have developed master agreements that provide for close out of positions and netting of exposure in the event of default. These agreements are legally effective in the event of bankruptcy in most, if not all, major jurisdictions. More favorable capital treatment of netting would actively encourage financial institutions to enter into such sound documentation for reducing risks. One suggested approach to more actively encourage netting is to allow for legal standards for netting that more closely follow actual market practice standards. Such standards include allowing netting for funding transactions where parties have a reasonable basis for concluding that the netting or offsetting of the netting agreement is enforceable in each relevant jurisdiction.

The Proposal should also recognize the reduction in credit exposures that can be achieved through legally effective cross-product master agreements. In February 2000, the Association published the Cross-Product Master Agreement (CPMA) jointly with eight other international trade associations. The CPMA is supported by legal opinions for the U.S. and the U.K., and the Association, in collaboration with other trade associations, is in the process of obtaining additional legal opinions to confirm the enforceability of this documentation, including in bankruptcy, in a substantial number of other major jurisdictions. Based on its own research, the Association respectfully disagrees with the Committee's statement in the Standardized Approach that "the legal enforceability of cross-product netting agreements is not considered to be sufficiently well tested in many jurisdictions to warrant recognition" (Paragraph 176). We urge the Committee to encourage the further development of such important risk mitigation efforts by according recognition to their true benefits.

Expansion of Government Repo-Style Carve-Out (Paragraphs 102-105 of the Proposal)

We commend the Committee for recognizing the very low risk associated with these products by carving out certain repo and securities lending transactions both from the *w* factor and from haircuts under the Standardised Approach. As noted above, the Association believes that, given such low risk, the haircut levels are inappropriately applied to funding transaction collateral, and that the *w* factor should be completely eliminated from the Proposal. The application of haircuts and the *w* factor to funding transactions that meet certain criteria is particularly inappropriate, and a carve-out from those rules is warranted.

As noted above, the effectiveness of credit risk mitigation techniques employed in funding transactions is evident in the low level of losses associated with such transactions. In addition, whether collateral used in funding transactions consists of sovereign debt securities or other types of collateral, such collateral often shares characteristics of sovereign debt, such as price transparency, liquidity, and settlement through a central clearing system.

In addition to the low levels of loss which funding transactions have historically demonstrated, such transactions should also be exempt from haircuts and the *w* factor given their central role in providing liquidity to the financial marketplace. Unlike other collateralized transactions, funding transactions play a crucial role in providing such liquidity. Given this important role, the imposition of additional costs on such transactions increases the risk of reduced liquidity, and is therefore unjustified.

The Association therefore believes that, given the important role funding transactions play in the broader financial market, the carve-out for such transactions should be broadened. Such broadened carve-out should be based *both* on the use of risk mitigation techniques and on the type of collateral used in such transactions. As presently drafted, the carve-out would only apply to a very narrowly defined category of "domestic transactions." The unfortunate effect of the carve-out, as currently drafted, is to penalize many other funding transactions that employ equally robust credit risk management practices and involve liquid securities collateral, such as exchange-listed equities. This creates a disincentive for market participants to adopt or maintain comparable practices for a wider range of transactions. The newly imposed costs may also serve to foster riskier trading practices with higher margins. Further, as noted above, with higher capital costs for dealer funding, the liquidity of the securities markets is likely to be adversely affected.

We therefore recommend that the carve-out in Paragraph 102 and 103 of the Proposal be expanded to include securities loans and repos in any securities that are "eligible collateral" under Paragraphs 76 to 79 of the Proposal or are otherwise appropriate to include in a financial institution's trading account.

The carve-out should also be available to securities lending or repo transactions whether they are conducted purely in a domestic market or internationally. Securities that settle in any settlement system approved and regulated by such settlement system's local national regulator or which otherwise routinely settle in such system should be included in the carve-out.[16]

Specifically, to qualify for the carve-out:

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[16] We recognize that a haircut for cross-currency exposures may be appropriate. However, the proposed uniform haircut of 8% does not take sufficient account of the correlation between certain currency values and the increasingly standard use of sophisticated correlation analysis to determine the appropriate currency haircut.

(1) the transaction would have to be marked-to-market daily;

(2) the transaction would have to be subject to daily remargining;

(3) both the exposure and the collateral would have to be "eligible collateral"[17] or instruments otherwise appropriate to include in the trading account;

(4) the collateral would have to be capable of being liquidated in no more than 4 business days;

(5) the transaction would have to involve securities that are settled in a settlement system approved and regulated by such settlement system's local national regulator or which otherwise routinely settles such securities;

(6) the transaction would have to be transacted under a master agreement that gives the nondefaulting party, upon the occurrence of an event of default, the right to promptly close out all transactions and liquidate collateral to establish a net settlement amount owed by one party to the other;

(7) the master agreement would have to be legally enforceable, including in the event of the insolvency of the counterparty (the standards of legal enforceability would be the same as those currently applied to netting agreements for off-balance sheet items under the current Basel Capital Accord); and

(8) the master agreement would have to be between "core market participants" (as defined in Paragraph 104 of the Proposal) or between any other counterparties in respect of which the agreement is legally enforceable, including in the event of their insolvency.

A funding transaction that satisfies the foregoing requirements should be subject to minimal risk of loss. Cross-border transactions, employing what is becoming increasingly standard domestic and international documentation, should qualify for the carve-out.

For similar reasons, the carve-out should also extend to margin loans that 1) involve "core market participants" (including both foreign and domestic "core market participants"), or any other counterparties in respect of which the agreement is legally enforceable, including in the event of their insolvency, 2) are collateralized by eligible collateral that can be liquidated in no more than 4 business days, 3) are marked-to-market daily, 4) are subject to daily remargining, 5) involve securities which are settled in a settlement system approved and regulated by such settlement system's local national regulator or which otherwise customarily settles such securities, 6) are covered by documentation specifying that if the counterparty fails to satisfy an obligation to deliver

[17] Note that, as described herein, the Association advocates the expansion of criteria for "eligible collateral" set out in the Proposal. Such "eligible collateral," as expanded, should be allowed in funding transactions eligible for the carve-out.

margin when due or otherwise defaults, the transaction is immediately terminable and the collateral may be liquidated, and 7) are subject to legally enforceable documentation, including in the event of bankruptcy of the counterparty. As long as these criteria are met, the risk profile of these transactions is not substantively different from that of "government repo-style" transactions and thus should be subject to the same capital treatment. Moreover, this treatment would provide a continued incentive for market participants to use effective legal documentation and other sound risk mitigation practices in margin lending.

Exempting low-risk transactions from the costs imposed by the *w* factor and the haircuts would provide an important financial incentive for the continued proliferation of sound risk-management standards in the funding markets. As discussed above, the Association shares the view of many of its fellow trade associations that the *w* factor is conceptually flawed and should ideally not be included in the Proposal. We believe a floor capital charge is particularly inappropriate for funding transactions that meet the criteria listed above.

Eligible Collateral (Paragraphs 76-79 of the Proposal)

Financial institutions should be permitted to recognize as eligible collateral in a repo, securities lending or margin lending transaction any securities eligible to be included in the trading book.

In addition, the list of "eligible collateral" should be expanded to include cash collateral irrespective of whether it is held "on deposit with the lending bank." Cash otherwise held by a collateral agent such as a third-party financial institution or custodian should be considered eligible collateral. The risk weight for cash collateral held by a financial institution for its own account should be 0%. Further, cash collateral held by a third-party custodian for a financial institution should also have a risk-weight of 0% where such financial institution's claim in respect of the cash collateral would rank ahead of other creditors of the custodian in the event of its insolvency. Otherwise, cash collateral held by a third-party custodian should have the risk weight of such third-party custodian.

Legal Recognition of Collateral (Paragraphs 68-71 of the Proposal)

The legal requirements that the Proposal sets forth for the recognition of collateral do not conform to industry standards and practices. These standards and practices are embodied in financial institutions' internal policies regarding the accepted documentation and procedures for obtaining a security interest (or equivalent rights) over various types of collateral in a number of jurisdictions. For example, while the Proposal would make legal opinions mandatory, under current practice a financial institution may not in all cases seek a formal internal or outside legal opinion confirming its legal position, particularly where short-term credit exposures and liquid collateral such as cash and

securities are involved. More commonly, a financial institution satisfies itself that it has a reasonable basis to conclude that it has a full title transfer, first priority security interest or equivalent unencumbered interest in the collateral. Where an opinion is obtained, it is normally updated when the applicable law is known to have changed, rather than at pre-determined regular intervals.

In addition, in multijurisdictional transactions where collateral may be held through a number of custodians and subcustodians, financial institutions consider the type of collateral, applicable choice of law rules, likely location of enforcement actions, and similar factors that provide a reasonable basis for them to reach the judgment that their rights in the collateral will be recognized in the event of default of the counterparty (including potential insolvency). We believe the legal requirements for recognition of collateral in the Proposal should more clearly reflect these rigorous industry standards of collateral management. Accordingly, we recommend that Paragraphs 68-71 of the Proposal be revised as follows:

Legal Certainty

68. Collateral is effective only if the legal documentation and requisite procedural steps have been taken which give the secured party:

    (a) ownership of the collateral subject to an obligation to return equivalent collateral, where the return obligation can be set-off against the secured obligation; or

    (b) rights in and to the collateral which are recognized, in the event of default by the debtor and in the event of the debtor's insolvency, in priority to rights of the debtor and of creditors of the debtor (other than liens or similar rights arising by operation of law).

69. A bank must have conducted sufficient legal review to have a reasonable basis to conclude that the foregoing requirements are satisfied and should have an internal process for assuring the requirements continue to be met in the event of changes in applicable laws.

70. The foregoing legal analysis should appropriately take into account multijurisdictional aspects, if any, of the collateral arrangements.

71. Where collateral is held by a custodian or by a financial intermediary, the contractual arrangements should provide that the collateral is held in such manner that it should not become part of the general assets of the custodian or intermediary in the event of the insolvency of the custodian or intermediary (customary liens of a central depository or clearing system are permissible).

CONCLUSION

The Proposal, as currently drafted, will greatly increase costs on certain funding transactions, without providing an incentive to maintain or improve upon existing robust credit risk mitigation practices. In addition to contradicting the stated goals of the Proposal, this result is also inappropriate given the low level of risk associated with such transactions, as evidenced by the low rate of loss such transactions have historically demonstrated. The Proposal should be revised to reflect more accurately the low level of risk such transactions actually present, and to achieve the stated goal of the Proposal not to increase the regulatory costs of engaging in such transactions.

While the Association commends the Committee's decision to allow financial institutions to internally determine haircut levels, it respectfully requests that the Committee clarify its position to state that financial institutions that create supervisory-approved risk calculation models be allowed to employ their own haircut levels. In addition, financial institutions should be allowed to calculate their haircut levels based on a reduced liquidation holding period consisting of 3 or 4 days at the most. The definition of "liquidation" should also be clarified to mean the time at which a trade is arranged to liquidate collateral.

In addition, the *w* factor should be eliminated. It is unclear what risks *w* is intended to represent. Regardless, given the low level of risk in funding transactions (as proven by the low level of loss such transactions have demonstrated), any risk *w* is intended to represent is either adequately captured in the level of haircuts, or is inapplicable to funding transactions given the credit risk mitigation practices such transactions employ.

Netting of exposures, while commonly employed as a risk mitigation practice in funding transactions, is not encouraged in the Proposal, since it does not appear to be addressed at all. The Proposal should set out guidelines for the netting of exposures in funding transactions effected pursuant to master agreements, and encourage additional risk mitigation practices, such as cross-product netting. If haircuts are applicable to such funding transactions, they should be applied on the net exposure.

While the Association believes that *w* should be eliminated from the Proposal across the board, and that haircut levels applied generally to funding transactions are excessive, it further believes that both haircuts and the *w* factor are particularly inappropriate for

funding transactions that meet certain criteria. Those funding transactions that employ a high level of credit risk mitigation techniques, quality collateral, and involve creditworthy counterparties, should not be subject to haircuts or the *w* factor. This is particularly true given the increased risk of illiquidity in the financial markets that is presented if the regulatory costs of engaging in funding transactions increases.

In addition to the provisions of the Proposal that deal with regulatory capital requirements, other provisions, such as the legal recognition of collateral and criteria for eligible collateral should be revised to more closely track actual market practice.

We hope the foregoing is helpful to you as you consider further refinements of the Proposal. We look forward to continued dialogue among the Association, our individual members and the Committee. Should you have any questions concerning this letter, please do not hesitate to contact me at 212.440.9474 or ooztan@bondmarkets.com.

Sincerely,

/s/ Omer Oztan

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17 May 2002

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Treatment of Collateralised Transactions

Dear Norah,

The International Swaps and Derivatives Association, the London Investment Banking Association and The Bond Market Association (collectively, "we" or the "Associations") appreciate the opportunity to respond to the letter dated 17 April 2002 (the "17 April Letter") from the members of the Basel Committee Capital Group's Subgroup on Credit Risk Mitigation ("Subgroup") regarding the treatment of collateralised transactions under the January 2001 Second Consultative Paper ("CP2") and the publication of a new Basel Accord (the "Accord"). We hope that, given the brief period the Associations had to respond to the issues raised in the letter, we were able to offer as detailed a response to the 17 April Letter as is warranted by the importance of the issues therein. The Associations applaud the Subgroup's continuing efforts to seek feedback from market participants, and hope in the future we will have more time to respond to the important issues raised by the Subgroup.

Summary of Key Points

We have set out our detailed response below to the issues raised in the 17 April Letter in the same order as such issues are set forth therein. Before presenting our detailed comments, we would like to call the Subgroup's attention to the following items of particular importance to the Associations.

Application of a multiplier to VaR-based measure: The Associations strongly disagree with the imposition of any ex ante multiplier greater than one for VaR-based aggregate counterparty exposures for capital purposes. The application of a multiplier is inappropriate given the inherently conservative nature of a VaR-based measure of aggregate counterparty exposure for the following reasons.

1) At the individual counterparty level, the VaR-based measure is significantly higher than the true loan-equivalent measure on a securities financing portfolio.
2) At the aggregate level, it ignores the diversification across individual counterparty exposures by implicitly assuming perfect correlation among all counterparty exposures.
3) The five-day exposure measurement horizon is substantially longer than the liquidation horizons to be expected from the regular practices on the US and a number of European markets. (See **VaR-Based Measure for Repo-Style Transactions.**)

Model validation and backtesting: The Associations agree with the need for appropriate model validation to validate a VaR-based measure of counterparty exposure, but believe the imposition of a backtesting regime to validate such VaR measure is not appropriate. The Associations further believe that the imposition of ex post multipliers based on exceptions to such backtesting regime is inappropriate. We suggest instead that model validation based on a variety of substantive and supervisory procedures will provide greater assurances to local regulators than would a backtesting regime similar to that in the Internal Models Approach under the 1996 Market Risk Amendment. Recognizing that the Subgroup might deem backtesting to be necessary, however, we propose a backtesting procedure and table of ex post multipliers. (See **Backtesting VaR Measures**.)

Netting of risk positions in the standard (non-VaR based) approach with master netting agreements: The Associations urge the Subgroup to consider permitting netting at the risk factor level, subject to review and approval by national regulators, as opposed to netting at the security level. (See **Master Netting Agreements**.)

Detailed comments

In this letter and the 17 April Letter, the term "VaR" refers to a probabilistic model of market risk factors used to assess counterparty potential exposure over a certain time horizon and with a certain statistical confidence level. The more traditional and commonly used VaR concept refers to "risk of loss" which is not equivalent to the concept of potential exposure: credit losses only occur if exposures and default occur simultaneously. Within this letter, we use the term "VaR-based" method or measure to refer to the methodology outlined within the 17 April Letter.

Simplification of the Formula for Collateralised Transactions

The 17 April Letter proposes to simplify the way haircuts are applied to collateral at the individual transaction level. The Associations note that the effect of the proposals is to modify the formula for applying collateral under the Comprehensive Approach (CP2, Paragraph 85), as follows:

$$E - C/(1 + H_E + H_C + H_{FX})$$

becomes

$$E - C + (EH_E + CH_C + CH_{FX})$$

The simplified formula recognizes the essential equivalence between haircuts and add-ons and thereby facilitates the application of a similar approach to both credit risk in repo-style transactions and other types of counterparty credit risk. Although the result of applying either formula will be numerically similar, the Associations believe the change represents an improvement.

Concern over the application of the exposure haircut/add-on (H_E).

The 17 April Letter states that exposure in the simplified formula be "grossed up, *where appropriate*, by a haircut reflecting volatility in the market price of the exposure" [emphasis added]. The Associations understand that H_E is meant to cover volatility in the collateralised asset, but suggest that the proposal would benefit from clarification of what would not be considered appropriate. The Associations believe, for example, that it would not be appropriate to apply H_E to a collateralised loan if the loan is not marked to market. In addition, applying the H_E factor to a collateralised swap exposure would overlap with the add-on factor already present in the calculation of these exposures. It should be clarified that the H_E

factor would not apply in such cases.

Finally, the proposed formula ignores the risk-reducing benefits of diversification by implicitly assuming perfect negative correlation between collateral and the underlying exposure. The proposal is neither realistic nor will it encourage diversification of a financial institution's trading portfolio. ISDA and LIBA have previously proposed using the greater of H_E or H_C to measure exposure for repo-style transactions in the trading book, and suggest that the Subgroup consider including this alternative.

Repo-Style Transactions and Holding Periods

The Associations believe that, as a general matter, assuming a five-day holding period is reasonable for repo-style transactions given current collateral practices. We would like to clarify our understanding of the effect of this change in the context of the haircut approach, which we believe amounts to replacing the equation set forth in Paragraph 98 of CP2, as follows:

$$H = H_{10}\sqrt{\frac{N+9}{10}} \text{ becomes } H = H_{10}\sqrt{\frac{N+4}{10}} = H_5\sqrt{\frac{N+4}{5}}$$

The Associations recommend, however, that the Accord leave the determination of a holding period to the discretion of national supervisors, with an understanding that regulators separately agree to a common standard for the exercise of such discretion. This approach would permit the holding periods to vary across transactions, and over time reflect differences in and the evolution of risk mitigation practices.

Master Netting Agreements for Repo-Style Transactions

The Associations agree with the Subgroup that "applying a transaction-by-transaction capital charge to a portfolio of repo-style transactions with a single counterparty" is inconsistent with the salutary risk-reducing effects of master netting arrangements. We are concerned, however, that the Subgroup's proposal to allow netting at the security level (where an internal model approach is not used) does not fully account for the offset of risks actually realised in such transactions. For example, a financial institution does not usually repo or lend securities to one counterparty and reverse in or borrow the same securities from the same counterparty. Netting at the security level is therefore likely to be only a modest improvement over netting at the transaction level.

Within an internal models calculation, netting operates at the level of risk factors, not of individual securities. For example, interest rate risks arising from government securities of differing maturities will be partially or wholly netted off. FX positions will similarly be netted across securities. A standardised netting proposal that does not recognise the offsetting of risk exposures at the risk factor rather than at the security level provides limited recognition of and incentives for adoption of netting.

Own Internal Estimates of Haircuts

The Associations welcome the decision of the Subgroup to expand the range of institutions that are eligible to use their own internal estimates to calculate haircut levels for collateralised transactions. We respectfully suggest, however, that the Subgroup seek to ensure that the costs of complying with the standards for review of such haircuts be commensurate with the degree of credit risk at issue. We further suggest that the level of sophistication required to adopt such standards is kept at a reasonable level. The standards should offer a realistic intermediate regime between supervisory haircuts and VaR modelling, which would encourage institutions to migrate towards more risk-sensitive capital measures.

VaR-Based Measure for Repo-Style Transactions

The Associations appreciate the Subgroup's decision to permit the use of internal models for securities financing transaction portfolios. Our members have used a range of models for capital allocation and credit risk pricing in such portfolios, and welcome the recognition of models for potential counterparty exposure measurements as well. While most of our members believe that Expected Positive Exposure is the best approach for integrating potential exposure into the IRB framework, we acknowledge that a VaR approach is considerably more risk sensitive than a standardised haircut method. The Associations therefore support the approval of VaR-based models for assessment of regulatory capital requirements for securities financing transactions as an interim solution, but recommend that the Accord provide financial institutions with the flexibility to develop and improve regulatory risk models over time.

Given the inherent conservatism of a VaR-based measure of counterparty exposure and the development by the industry of conceptually more appropriate measures of potential exposure, the Associations strongly encourage the Subgroup to refrain from: (1) imposing an ex ante multiplier greater than one in the context of a VaR-based capital requirement, (2) setting out a specific calculation method for loan-equivalent exposure for secured financing transactions, and (3) mandating a detailed backtesting regime or ex post multipliers based on such regime. The remainder of this section sets out our arguments in more detail.

Conservatism of a VaR Approach

It is the Associations' understanding that "VaR" in the 17 April Letter refers to a method of measuring potential future counterparty exposure, using a 99th percentile, one-tailed confidence interval, and assuming a five day holding period. The Associations believe that this VaR-based method is an overly conservative measure of counterparty risk for the following reasons.

1) On an individual counterparty basis, the VaR-based measure of exposure is far higher than a loan-equivalent measure to which risk weights should be applied. This asymmetry arises in part because the VaR-based method treats a potential exposure amount (which is unlikely to be realised) as equivalent to a loan exposure (which exists with certainty). Further, the VaR approach fails to recognise that, for a given portfolio volatility, the more current exposure exceeds zero, the less the incremental credit risk that arises from fluctuations in portfolio value. This exacerbates the asymmetry effect because exposure can fall as well as rise when current exposure exceeds zero.

2) The risk-weights have already been calibrated to a 99.9% confidence level. The combined effect of measuring counterparty risk by using a 99th percentile VaR measure with the IRB function's 99.9th percentile loss distribution target results in an overly conservative measure of exposure. There is, in general, no reason why market and credit risk factors should conspire to produce such a result.

3) Summed across counterparties, the VaR-based method ignores the diversification across individual counterparty exposures and implicitly and effectively assumes perfect correlation among all counterparty exposures. Diversification occurs, for example, when an exposure on one side of a matched book offsets another counterparty's exposure on the other side. In addition, many counterparties have positions that are not strongly correlated with either side of the matched book.

4) The five-day exposure measurement horizon is substantially longer than the liquidation horizons suggested by regular practices in the US and a number of European markets.

Imposition of an Ex-Ante Multiplier is Inappropriate

The 17 April Letter mentions the possibility of imposing a multiplier, possibly equal to three or more, on VaR used for exposure measurement. Such a multiplier could take two forms, and either be imposed: 1) ex ante regardless of the results of backtesting and model validation, or 2) ex post as a penalty or to remedy apparent defects which have been revealed by backtesting or model validation of an institution's calculation.

The Associations strongly oppose the imposition of an ex ante multiplier. First, there is no conceptual foundation for such a multiplier. Second, in practice an ex ante multiplier greater than one would exacerbate the unduly harsh treatment of credit risk in securities financing transactions relative to loan credit risk that we mention above. To go even farther by imposing an ex ante multiplier of three would produce a capital requirement far beyond any reasonable *minimum* capital requirement.

The Associations also oppose the imposition of an ex post multiplier as a penalty for exceptions to a backtesting procedure; we describe our reasoning under "Backtesting VaR-based Measures." The Associations recognise, however, that the Subgroup is considering a backtesting regime. We therefore outline below a backtesting methodology and an ex post multiplier table.

Accord Should Maintain Flexibility

The Associations believe that the Accord itself should not mandate the use of specific models of potential counterparty exposure. Instead, we suggest that the Accord provide flexibility for internal models to be adapted to the specific risk characteristics of a firm's portfolio and to evolve over time as risk exposures change and risk measurement methods improve. More specifically, the Accord could require that a firm calculate the "loan equivalent" value for credit exposure arising from its securities financing transactions. The loan equivalent exposure would then be treated as a loan exposure under the Accord. National supervisors would review and either approve or disapprove the particular models proposed by firms to calculate their loan equivalent exposures.

This approach is similar to many regulators' current treatment of derivatives pricing models in the context of regulatory capital for current exposure. The supervisor reviews the theoretical adequacy and practical efficacy of a pricing model but does not mandate the details of model structure a priori. The model's valuations are a central determinant of the capital requirement for current credit exposure for transactions covered by the model.

In the context of repo-style transactions, an optimal balance of standardisation and flexibility might involve supervisors agreeing among themselves on more detailed model requirements (initially a VaR-based measure with a particular confidence level and time horizon) outside the Accord. A major benefit of this approach is that standards could evolve as appropriate over time without the need to undertake a cumbersome modification of the Accord.

Backtesting VaR-based Measures

The Associations do not support inclusion in the Accord of a backtesting regime or of an ex post multiplier as a penalty. As the Subgroup recognizes in the 17 April Letter, the backtesting required for market risk VaR is not necessarily appropriate in the context of measuring counterparty risk in repo-style transactions.

Model Validation is Appropriate Method of VaR Model Approval

The Associations suggest that, instead of a specified backtesting regime, the Accord provide for a system

of model validation that is capable of evolving over time to reflect ongoing improvements in risk measurement methods. Model validation would include regulatory review and approval of models used in the calculation of regulatory capital for secured financing transactions. There are precedents to such an approach, including the model validation performed now by most regulators for valuation models. Another precedent is the approach outlined in Paragraphs 230 and 231 to the Internal Ratings Based Approach Supplement to CP2, which expresses the intention to develop internal ratings validation methods without prescribing a particular approach in advance. The Accord should similarly avoid a prescriptive approach to backtesting, and instead provide national supervisors with principles to follow when reviewing a financial institution's model for approval.

Suggested Backtesting Method

If a prescriptive backtesting approach is deemed necessary to validate a VaR counterparty risk model, the Associations suggest the following backtest, which would be performed annually:

- At the beginning of a quarter, the institution identifies the 20 counterparties to which it has the largest credit exposure (based on internal measures) and 20 other randomly selected counterparties.
- For each day in the succeeding quarter, a random counterparty is selected from this group of 40.
- The financial institution, which maintains daily activity data for its VaR calculations, measures (1) that day's change in the value of the counterparty's exposure, "cleaned" to strip out any collateral flows for the day, and (2) the VaR calculated as of the previous close of business for such day for such counterparty.
- An exception occurs for each day on which "cleaned" P/L exceeds VaR.
- In the "hard" form of the test (see below), the following table of ex post multipliers would apply in the case of different numbers of exceptions.

Table of multipliers. The Associations propose the following.

Number of exceptions	Significance	Multiplier
0	91.80	No action necessary
1	71.30	No action necessary
2	45.60	No action necessary
3	24.60	No action necessary
4	10.90	No action necessary
5	4.20	1.13
6	1.40	1.17
7	0.40	1.22
8	0.10	1.25
9	0.03	1.28
10	0.01	1.33

Significance is the probability of a properly functioning model arriving at a given number of exceptions (violations) purely by chance (rather than the model not functioning properly).

If the number of exceptions exceeds ten, there will be a presumption that the model is not functioning properly. Banks will calculate a multiplier according to the formula described below, subject to national supervisory discretion to set it higher. The new multiplier will remain in effect until the earlier of: (1) the approval by supervisors of a revised model; or (2) six months has passed, after which banks will be required to calculate capital using standardised haircuts.

The multiples in the above table are derived in a manner analogous to those used in the 1996 Market Risk Amendment scaled according to the following formula:

$$Multiplier = \frac{2.33}{\left(F^{-1}\right)\left(1 - \frac{X}{N}\right)}$$

where:

F = the cumulative distribution function for the normal distribution

X = number of exceptions (assuming 5 or greater)

N = number of observations.

In drawing up this suggestion, the Associations accounted for the following two considerations, which

effectively restrict the range of possible backtests to the procedure suggested above.

- *Statistical power.* In the backtesting regime for market risk, significance (in effect, severity) is assigned to each possible number of exceptions based on the probabilities of certain outcomes having the binomial distribution. The application of this distribution is broadly acceptable because individual days from the time series can reasonably be considered to be independent. To be able to make a corresponding assumption here, it is necessary to construct a backtest in which *only one counterparty is tested on each day.*
- *Practicality.* The amount of data involved in backtesting a single counterparty in the current context would be comparable to the total work involved in a market risk backtest over the same time period. Based on the Associations' knowledge of the resources required for a market risk backtesting regime, we believe it would be neither practical nor cost effective to mount a similar effort for securities financing transactions.

A compromise approach

To overcome the drawbacks of the proposed backtest while retaining its useful features, we propose the following alternative approach.

- Firms will be required to gain approval for their risk measurement model validation procedures. The backtest proposed above could form part of this model validation procedure, but need not be applied precisely in the form proposed above. In particular, a bank supervisor might select counterparties of particular concern or interest. It is important to note, however, that in this "soft" form the backtest should not be linked directly to multipliers as proposed in the above table.
- If a firm cannot gain approval or if it chooses not to develop a validation procedure, then it could be made subject to the full backtest above including the table of multipliers.

Residual Risks

The Associations welcome the decision of the Subgroup to address residual risk in the Pillar 2 supervisory review process of the Accord. We affirm our commitment to assist the Subgroup in developing a robust framework in Pillar 2 for addressing residual risk.

The Associations appreciate the Subgroup's request for comment on the 17 April Letter and their willingness to consider our response. We sincerely hope the comments will be useful to the Subgroup's deliberations, and look forward to further dialogue on these important issues. If you have any questions regarding our response, please feel free to contact any of the undersigned.

Yours sincerely,

Emmanuelle Sebton	Katharine Seal	Omer Oztan
ISDA	LIBA	TBMA

The Real Estate Roundtable

March 11, 2003

The Honorable Peter King
Chairman
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
Committee on Financial Services
U.S. House of Representatives
Washington DC 20515

Re: Comments on The New Basel Capital Accord

Dear Mr. Chairman:

The Real Estate Roundtable (*www.rer.org*) is providing these comments to the Subcommittee on Domestic and International Monetary Policy, Trade and Technology ("Committee") on the New Basel Capital Accord ("New Accord"), in conjunction with its hearings on February 27, 2003.

The New Accord could have a significant negative impact on the flow of credit to the commercial real estate industry and, thereby, affect its overall liquidity and valuation. As such, we appreciate the opportunity to provide the Subcommittee, as well as the US banking regulatory agencies, with our concerns about the New Accord.

The Real Estate Roundtable and its members lead an industry that generates more than 20 percent of America's gross national product, employs more than 9 million people and produces nearly two-thirds of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the US's leading income-producing real property owners, managers and investors, the elected heads of America's leading real estate trade organizations, as well as the key executives of the major financial services companies involved in financing, securitizing or investing in income-producing properties.

Unintended Consequences of the New Accord

The Real Estate Roundtable ("the Roundtable") would like to commend the Subcommittee for its work toward examining the work of the Bank for International Settlements and the corresponding work of the US regulatory agencies. Clearly, there are benefits to a more fair and consistent conceptual risk capital framework in our global financial services system. By more closely aligning regulatory capital with economic capital, the New Accord has the potential to improve the relative allocation of capital to more closely reflect actual differences in risk. While the Roundtable believes that the New Accord makes significant progress toward greater risk transparency, we also have serious concerns about the potential for significant unintended consequences — both for the real estate sector and the overall economy — that an inappropriately calibrated new regulatory capital regime can generate.

Subcommittee on Domestic and International Monetary Policy, Trade and Technology
March 5, 20003
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The Roundtable generally supports the US regulatory agencies' proposed ratings-based, multi-level approach that would directly link capital requirements and levels to the rating assigned to a particular asset securitization position. We believe that such an approach, with certain refinements, would provide banking organizations with an improved, more efficient regulatory capital framework. It would also afford banks far greater flexibility than they now enjoy in managing their credit exposure through various investments, credit enhancement activities and securitization strategies.

However, the New Accord deviates from its variable risk-weighting approach when it assigns a 100% risk-weight for commercial mortgages regardless of the credit of the obligor. This is especially unfair when one considers that CMBS that are collateralized by these same commercial mortgages are able to achieve risk weights of as low as 20% for the highest quality investment grade offerings. These proposed unreasonably high risk weights for both commercial and residential loans could make real estate lending in general much less profitable and desirable to banks. As a result overall real estate lending may drop quickly. It is also anticipated that the new risk-weight assignments for securities will discourage banks from investing in CMBS. In short, these capital increases, coupled with rules that are not directly linked to economic risks, could have negative consequences for lending to real estate. Reduced lending, particularly as the economy continues to struggle, could be expected to further weaken property values and undermine overall market liquidity.

The Roundtable strongly urges the Subcommittee to request additional comments on the impact of the proposed accord on the US economy and affected industries and to provide opportunity for continued industry comment on additional changes to the accord necessary to mitigate the sectoral and macroeconomic concerns.

We trust the Subcommittee may find our comments useful. Should you have questions or require additional information, please contact Clifton E. Rodgers, Jr. by telephone at (202) 639-8400 or by email at crodgers@rer.org.

Thank for this opportunity to comment on this important issue.

Sincerely,

Jeffrey D. DeBoer
President and Chief Operating Officer

cc: Honorable Michael G. Oxley, Chairman, Committee on Financial Services, U.S. House of Representatives, Room 2157 Rayburn House Office Building, Washington, DC, 20515

Board of Governors of the Federal Reserve System, Basel 2001 Capital Proposal, Mail Stop 179, 21st and C Streets, NW, Washington, DC 20551

Basel 2001 Capital Proposal, Office of the Comptroller of the Currency, Mail Stop 3-6, 250 E Street, SW, Washington, DC 20219

Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429

Honorable Peter R. Fisher, Under Secretary for Domestic Finance, U.S. Department of the Treasury, 1500 Pennsylvania Avenue, NW Washington, DC 20220

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